New York State Legislative Commission on the Future of LIPA

Testimony of Thomas Falcone, Chief Executive Officer of the Long Island Power Authority

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I. Introduction

Thank you, Chairs Thiele and Thomas, Executive Director Lancman, and distinguished members for holding today's hearing and inviting me to address the Committee. This will be a meaningful discussion of an important topic – the future of electric service for Long Island and the Rockaways.

My name is Thomas Falcone, and I am LIPA's Chief Executive Officer. I have been involved in the electric utility industry in various capacities for over 20 years. Prior to joining LIPA, I was an investment banker and advisor to many of the largest public utilities in the United States, raising more than $25 billion for infrastructure investments across the country. My work as a banker included advising clients on public-private partnerships.

I joined LIPA in 2014 and served as Chief Financial Officer and Chief of Staff before becoming CEO in 2016. I am active in several national utility associations. I currently serve as Vice Chair of the Large Public Power Council, representing the 27 largest public power systems in the nation, collectively serving over 30 million customers. I'm also a board member of the American Public Power Association, the trade association for the more than 2,000 local and publicly owned electric utilities. I also sit on the Board of the Association of Edison Illuminating Companies, where executives from 185 major electric companies come together to share best practices in utility operations.

II. LIPA's Business Model

First, I want to provide a brief background on LIPA's model for delivering electricity to its 1.2 million customers.

LIPA is a not-for-profit, public power utility created by the State Legislature in 1986. Although LIPA is the owner of the electric transmission and distribution system serving our community, LIPA has contracted out the day-to-day operations of the electric grid to neighboring utilities since its purchase of the Long Island Lighting Company (LILCO) in 1998. From 1998 to 2013, LIPA was the customer-facing brand, but KeySpan and later

National Grid were the management service providers. Following the LIPA Reform Act of 2013, PSEG Long Island has served as both the management service provider and the customer-facing brand of the utility.

The utility is governed by the LIPA Board of Trustees, consisting of nine unpaid customers appointed by the Executive and Legislative branches. The LIPA Board contracts with and oversees vendors, sets policy, strategy, budgets, and performance metrics, finances the infrastructure investments necessary for a reliable electric grid, and leads Long Island's clean energy transition. The LIPA management team supports the Board and brings extensive utility experience in all core business functions.

LIPA shares oversight responsibility with the Department of Public Service Long Island Office, which was created by the LIPA Reform Act of 2013. DPS Long Island, among other things, recommends PSEG Long Island's annual Emergency Response Plan, audits both LIPA and PSEG Long Island, and makes independent recommendations to the LIPA Board.

III. <u>Tropical Storm Isaias Investigation and PSEG Long Island Contract Reforms</u>

In the wake of Tropical Storm Isaias in August 2020, LIPA and DPS independently conducted thorough investigations of the problems encountered by PSEG Long Island. These investigations concluded that management problems were the root cause. Further, PSEG Long Island management was not candid with LIPA and DPS about what it knew before, during, and after the storm. After evaluating LIPA's options for terminating or revising the PSEG Long Island contract, the LIPA Board approved a substantially reformed contract that became effective in April 2022.

Among the key reforms in the new contract are:

- strict "pay for performance" measures that directly affect the majority of PSEG Long Island's compensation;

- a commitment to a fully staffed, dedicated management team for LIPA's operations;
- separate IT systems for Long Island;
- stronger contract termination rights; and
- new oversight rights for both LIPA and DPS, including the right to independently verify and validate the testing of all mission-critical IT systems.

Most significantly, the management agreement was effectively shortened from 12 years to four by eliminating PSEG Long Island's option to extend the contract upon its expiration in 2025.

IV. Utility Performance

Next, I would like to address utility performance. The LIPA Board of Trustees has set out detailed expectations for the strategic outcomes that LIPA and PSEG Long Island management should deliver. These Board Policies are available on LIPA's website. These expectations include:

- a carbon-free electric grid by 2040, as required by the Climate Leadership and Community Protection Act passed by the Legislature in 2019;
- a highly reliable and resilient electric grid among the top 10 percent of peer utilities;
- electric service at the lowest possible cost through efficient operations and plans that maximize customer value; and
- an outstanding customer experience among the top 25 percent of electric utilities.

The LIPA Board has also insisted we accomplish these goals in a fiscally sound and sustainable manner.

LIPA has made significant progress on several Board priorities. LIPA is leading our region's transition to clean energy and towards the goals of New York's Climate Act. Committed clean energy projects will reduce LIPA's carbon footprint 72% by 2030. LIPA has also invested a record $5.7 billion in infrastructure since 2016 – nearly three times the prior level of investment – leading to a 37% reduction in power outages and nearly a top 10% national ranking among utilities in reliability. LIPA has made these investments while minimizing costs to our customers by taking advantage of our tax-exempt cost of capital along with $1.8 billion of federal grants for storm restoration and hardening. These grants are available only to publicly-owned utilities.

Although rates have risen, electric bill increases remain below the rate of inflation and the increases of neighboring utilities. And we have reduced our leverage and obtained four credit rating upgrades, with Fitch Ratings putting us on a "positive outlook" for a potential fifth upgrade in the next 12-18 months.

The LIPA Board has set high expectations for the customer experience, but we have struggled to achieve them. The Board has invested substantial resources to provide a better experience for customers. Operational improvements from smart meters have led to better billing performance, but PSEG Long Island ranks in the fourth quartile of peer utilities on customer satisfaction as measured by J.D. Power.

After only seven months, it is still too soon to determine the performance impacts of the recently reformed PSEG Long Island contract. Many of the new performance metrics are on track for success, while others are at risk. The LIPA Board is committed to transparency and accountability and staff has issued public quarterly reports evaluating PSEG Long Island's performance in detail, with the most recent having been released two weeks ago.

However, I do believe that the reformed contract has led to greater responsiveness and engagement from PSEG Long Island management and greater visibility into the progress of agreed-upon projects and initiatives. We will continue to keep the LIPA Board and public apprised of our progress.

V. *LIPA's Options*

With the PSEG Long Island management contract expiring at the end of 2025, now is the time to plan for the future management of LIPA's assets. Following Tropical Storm Isaias, the Board and DPS asked LIPA staff to evaluate options for improving the management of the utility. This resulted in an Options Analysis that was issued to the public in April 2021. In addition to reforming the PSEG Long Island contract, LIPA evaluated three other options: 1) privatization; 2) rebidding the contract to a new service provider; and 3) bringing utility operations under LIPA management.

1. Privatization

First, to discuss privatization, LIPA's purchase of LILCO, a private, investor-owned utility, resulted in a 20 percent reduction in customer bills upon completion of the merger in 1998; that financial advantage continues today. Public ownership reduces Long Island customer bills by an estimated $32 per month for a typical residential customer.

Privatization of the Long Island electric grid has been studied on at least five occasions (1998, 2005, 2011, 2013, and again by LIPA in 2021). Each of these studies concluded that the higher costs of an investor-owned utility would be disqualifying.

Utilities are asset-intensive businesses, and the cost of capital is a significant component of the cost to customers. Not-for-profit public power provides access to lower-cost tax-exempt financing and exemption from federal corporate income taxes. LIPA does not have shareholders or pay dividends, and all funds are dedicated to providing service to customers. Public power utilities are also eligible for federal grants for storm restoration and hardening, and LIPA has benefited from $1.8 billion of such grants in the last decade.

The higher cost of capital and loss of federal grants associated with privatization cannot feasibly be offset by operating "synergies" for the reasons demonstrated in our report. As a result, LIPA customers would incur substantial rate increases, cuts to service, and/or lower levels of investment in the electric system under private ownership.

2. Outsource to a New Service Provider to Improve Operations

The second alternative LIPA evaluated was rebidding the PSEG Long Island contract to competitively select the next provider.

The management outsourcing model that LIPA has employed since 1998 always contemplated the transition to new service providers depending on the performance of the incumbent contractor and the evolving needs of LIPA and its customers. LIPA executed such a transition on January 1, 2014, with PSEG Long Island taking over the day-to-day management of operations from National Grid.

The next management contract would likely extend for a decade and involve over $1 billion of management fees. The Office of the State Comptroller stated upon its approval of the April 1, 2022 reformed PSEG Long Island contract that it will not consider an extension of that contract without a competitive bidding process. PSEG Long Island would be welcome to bid but would be in the same position as other bidders. A rigorous and competitive bidding process could identify the contractor(s) that most strongly align with the management orientation, capabilities, and collaborative mentality that LIPA seeks. A bidding process also provides an opportunity to further strengthen the contractual framework and management incentives of the contract to better align with the LIPA Board's vision for customers.

LIPA's management model is not widely used in the industry; however, there is a ready market of potential vendors that can manage T&D operations, IT, billing, customer service, and other customer-facing functions. PSEG Long Island already uses several firms to perform these utility functions, with good results for customers in terms of cost and service. In 2021, when PSEG Long Island contract reform negotiations appeared unpromising, LIPA issued a request for interest among potential firms, and the initial response was encouraging, so we do believe this is a viable option if vigorously marketed to potential providers.

LIPA could also seek to split the management contract into multiple scopes of service. Contracting with multiple vendors provides the flexibility to retain well-performing partners while replacing those that do not meet expectations without incurring significant switching costs.

The actual cost and terms for one or more new contractors would not be known until the conclusion of the solicitation and contract negotiations, which would take approximately a year.

3. Bring Utility Operations Under LIPA Management

The third alternative is to place LIPA's assets under its direct management. This involves hiring staff to provide the management services currently outsourced to PSEG Long Island. Principally, this includes 19 senior managers, as well as the in-sourcing of certain services provided by PSEG affiliate companies in the areas of IT, human resources, procurement, and treasury. Together, the management fees and affiliate expenses run approximately $100 million annually, and the Options Analysis estimated they could be replaced for $25 million per year. With estimated annual savings of $75 million, the one-time transition costs of $20 to $30 million[1] would be recouped within the first year.

Nationally, non-profit, public power utilities have a strong record of performance, including in customer satisfaction, reliability, clean energy, and cost. While that does not assure success, it does demonstrate an established pool of talent, experience, and best practices available to LIPA.

The Options Analysis also discussed the key risks of the public management model, including:

- Management quality – to be successful, the utility must be managed by seasoned professionals whose own careers and compensation are explicitly linked to verifiable and transparent measures of performance.

[1] This one-time transition cost estimate from the Options Analysis assumes that the PSEG Long Island contract expires on December 31, 2025 and transition occurs on that date.

- Second, a transition to LIPA management would require customer and stakeholder outreach, including communication of an explicit and credible promise of performance.
- Third, a performance-focused governing body will play a critical role in ensuring a customer-first utility. The Board must continue to ensure that management is accountable for delivering on promised levels of service for customers.

Finally, I'd like to briefly discuss the transition. Whether LIPA selects a new management provider or moves to a LIPA management model, we will need to execute a transition plan that:

- mitigates the risks involved in filling out the management structure for the 19 employees provided by PSEG Long Island;
- shifts the 2,500 permanent "ServCo" employees to new management without adversely affecting their compensation and benefits; and
- ensures the smooth migration and handoff of mission-critical operations.

The revised contract with PSEG Long Island requires that all IT systems and support organizations be fully migrated to Long Island management by the end of the current contract, which will significantly reduce system transition risks. The contract also has explicit transition services provisions to facilitate the handoff between old and new providers. Overall, the scope of transition activities is well-defined and well-known to LIPA and can be completed within approximately 12 months.

VI. Conclusion

I look forward to the continued discussion with this Commission as we work towards the customer-first utility Long Island and the Rockaways deserve – one that is clean, reliable, and affordable.

Thank you, and I would be happy to answer your questions.

Reference Material

- LIPA Phase II Options Analysis dated April 28, 2022
- LIPA Board of Trustees Policies on Strategic Outcomes
- Quarterly Report to the LIPA Board on PSEG Long Island Performance Metrics dated November 16, 2022
- Reformed Contract with PSEG Long Island
- LIPA's 2023 Proposed Annual Budget