



Long Island Power Authority

Considerations for Rate Setting

December 2005

New York State
Office of the State Comptroller
Alan G. Hevesi

Deputy Comptroller Kim Fine
Office of Budget and Policy Analysis
Albany, New York 12236

In an effort to reduce the costs of printing, please notify the Office of Budget and Policy Analysis at (518) 473-4333 if you wish your name to be deleted from our mailing list or if your address has changed.

Additional copies of this report may be obtained from:

Office of the State Comptroller
Public Information Office
110 State Street
Albany, New York 12236
(518) 474-4015

Or through the Comptroller's website at: www.osc.state.ny.us

Table of Contents

EXECUTIVE SUMMARY	3
IS THE PROPOSED RATE INCREASE CONSISTENT WITH LIPA'S MISSION AND LIPA'S PLANNED ORGANIZATIONAL STRUCTURE?	11
WHAT HAS THE EFFECT OF SURCHARGES BEEN ON RATEPAYERS AND THE LONG ISLAND ECONOMY?	15
WERE SURCHARGES LAWFUL AND APPROPRIATE, AND IS LIPA'S CALCULATION OF FUEL AND PURCHASED POWER, USED TO JUSTIFY SURCHARGES, REASONABLE?	21
DOES LIPA NEED TO MAKE IMPROVEMENTS TO COST ESTIMATES?	31
WHAT COSTS HAVE GROWN IN LIPA'S BUDGET, AND WHAT ARE THE OPPORTUNITIES TO CONTROL COSTS?	33
WHAT HAS LIPA DONE TO MITIGATE COST INCREASES, AND WHAT ARE THE POTENTIAL LONG-TERM EFFECTS OF THESE ACTIONS?	39
ARE THERE COMPARABLE UTILITIES THAT PROVIDE LESSONS FOR LIPA IN MANAGING COSTS?	43
HAS LIPA'S BOARD BEEN ADEQUATELY INVOLVED IN DECISION MAKING AS RELATED TO RATEPAYER COSTS?	49
ADDITIONAL CONSIDERATIONS.....	55
APPENDIX A	59
APPENDIX B	60
APPENDIX C	61

Executive Summary

On October 7, 2005, it was reported that the Chairman of the Long Island Power Authority (LIPA) would seek approval from the Public Service Commission (PSC) in 2006 for a base rate increase. The plan to request a base rate increase followed criticism of the seventh surcharge imposed by LIPA that raised the average price of electricity for ratepayers by passing along to them increased costs for fuel and purchased power.

Despite the fact that LIPA's base rate has not changed since May 1998, the average price LIPA customers pay for electricity has increased. In 1999, LIPA's first full year of running the transmission and distribution system, Long Islanders paid 83 percent more for electricity than the national average—in 2004, Long Islanders paid 96 percent more than the national average. Surcharges have had the cumulative effect of increasing LIPA's average residential customer's bill by \$630 annually and could have as much as a \$3 billion negative impact on Long Island's economy.

This report was developed in response to a request from Assemblyman Marc Alessi that Comptroller Hevesi, who has conducted several reviews of LIPA's finances and operations, recommend issues the PSC should consider in reviewing the rate increase LIPA plans to request. It is important for LIPA to initiate this process soon and for the PSC to ensure that it is a public process, providing Long Islanders with an opportunity to consider findings as they weigh the series of organizational alternatives LIPA is expected to unveil before the end of December.

The potential for PSC review is a welcome development, since the surcharges have been imposed without any form of regulatory oversight. Regulatory review of rate setting by the PSC is intended to ensure that increased costs passed along to consumers are both necessary and reasonable. The State Public Service Law specifically places the burden of proof with the utility to adequately demonstrate that the proposed rate increase is reasonable and just.

In determining whether LIPA's request is reasonable and just, energy industry experts at the Department of Public Service who advise the Commission should examine the following:

Is the proposed rate increase consistent with LIPA's mission and planned organizational structure?

The Long Island Power Authority was created to correct mistakes by a private utility that produced a threat to the local economy in the form of high energy costs. Equally important, LIPA was intended to restore the confidence of ratepayers and government officials that electricity could be supplied on Long Island in a reliable, efficient and economic manner. The Authority was expressly charged with decommissioning the Shoreham Nuclear Power Plant and lowering prices. The plant was successfully decommissioned in 1994, and LIPA has taken significant steps to increase capacity and strengthen reliability. Whether LIPA's actions have been efficient and economic is a matter for further analysis.

LIPA has initiated a process to consider options for the Authority's future, including privatization. The Authority hired lawyers and finance experts to assist in the deliberations. It is expected that LIPA will release the results of its study on privatization and other alternatives on December 15, 2005—LIPA's deadline for making a decision about purchasing former LILCO power plants from KeySpan.¹ When the study was initiated, LIPA's Chairman said it would result in a business plan that would be subjected to public discussion to assist in making "whatever strategic decisions are necessary to have the best electric system in the country."²

The Suffolk County Long Island Power Authority Advisory Panel, established by County Executive Steve Levy, recently offered LIPA a series of recommendations relevant to its strategic organizational review. In addition to advising against the purchase of generating capacity, the Panel recommended a change in LIPA's corporate organization and greater day-to-day operational management by KeySpan.

¹ LILCO, the Long Island Lighting Company, was the utility serving Long Island before LIPA.

² Statement by Richard M. Kessel, Chairman, Long Island Power Authority, April 7, 2004.

LIPA's original mission and its anticipated organizational structure for the long term should be considered by the PSC in assessing any requested rate increase.

What has the effect of surcharges been on ratepayers and the Long Island economy?

LIPA's average electric prices are higher than the national average, State average and nearly all of the largest electric utilities in the nation. In its first year of operation, LIPA's customers paid electric prices that were 83 percent higher than the national average. In 2004, LIPA's prices were 96 percent higher than the national average—and LIPA has imposed two surcharges since reporting that data to the federal Energy Information Administration.

A 2003 economic impact study on LIPA's base rate cut, implemented in 1998, estimated that each dollar added to a Long Island household's disposable income "turns over at least five times a year" to help stimulate the regional economy.³ The study estimated that "the \$2.5 billion that LIPA has injected into the Long Island economy through rebates and rate reductions during its five-year existence has expanded the region's economy by some \$12 billion."⁴ Employing the same assumptions, the \$600 million that will be taken away from Long Island households because of LIPA's excess fuel cost surcharges could have a \$3 billion negative impact on Long Island's economy in 2006 alone.

Surcharges also have affected LIPA's commercial customers. In the commercial and industrial sectors, manufacturing represents some of the most energy intensive industries. Long Island has seen its manufacturing base decline due, in part, to historically high energy costs. A study exploring the economic impacts associated with opening a plastics factory on Long Island identified several disadvantages. The study found that Long Island would have the eleventh highest operating costs among 125 sites nationwide and identified energy costs as a major contributor to the high costs of operations.

³ Keller, Dr. Irwin. "Economic Benefits of LIPA's Rate Cut for Long Island." 2003.

⁴ *Ibid.*

Were surcharges lawful and appropriate, and is LIPA's calculation of fuel and purchased power, used to justify surcharges, reasonable?

LIPA must be required to justify its continued use of surcharges in light of the resolution passed by the Public Authorities Control Board in 1997 prohibiting the Authority from increasing rates by more than 2.5 percent during a 12-month period without approval by the PSC following a full evidentiary hearing. The resolution—which also called for an overall 14 percent decrease in rates as compared to LILCO's base rates—did allow for the average rate to be adjusted to reflect emergency conditions, including unforeseen increases in fuel prices. LIPA's Tariff for Electric Service also provides for this.

The PSC must determine if LIPA interpreted and employed these provisions as intended. In making this determination, the PSC also must consider LIPA's operational definition of fuel and purchased power. For example, are costs associated with long-term power purchase contracts "emergency" or unforeseen? If they can be considered unforeseen in the first year of the contract, how should they be treated in subsequent years?

Further, it appears that LIPA has defined fuel and purchased power costs more broadly than is standard in the electric industry and Public Service Law. This has contributed to the fact that, between 1999 and 2006, LIPA's budget for fuel and purchased power has increased by \$1.5 billion, or 232 percent. During the same period, LIPA has added, deleted and combined costs in its fuel and purchased power costs, ultimately resulting in 19 cost categories included in its 2006 proposed budgeted amount. Cumulatively, costs added to the definition have increased LIPA's budgeted fuel and purchased power costs by more than \$311 million.

Does LIPA need to make improvements to cost estimates?

Estimates, by their nature, are often wrong. In the case of estimates about energy prices, there are so many influencing factors that predictions are particularly difficult. LIPA has engaged PACE Global Energy Services as an energy risk advisor. PACE issued a report in April 2005 noting that energy prices will remain high. In its 2006 proposed operating budget, released in October 2005, LIPA predicts that by 2010, its fuel and purchased power costs will decrease. This inconsistency may help explain why LIPA's surcharge predictions have

not accurately reflected actual changes in the surcharges imposed on its customers.

Rate proceedings should include an examination of LIPA's methods for estimating fuel costs to date and the industry experts at the Department of Public Service should advise LIPA on ways to improve its estimates. This will be particularly important to ratepayers since, even if a base rate increase is approved, LIPA will likely continue to be allowed to recover excess fuel costs. It is hoped, however, that the rate proceedings will better define acceptable costs to be recovered and action will be taken to ensure that only costs that truly could not reasonably be predicted will be recoverable via surcharge.

What costs have grown in LIPA's budget, and what are the opportunities to control costs?

LIPA expends its revenues in three primary cost categories: operations and maintenance (O&M), debt service, and payments in lieu of taxes (PILOTS). Information supplied by LIPA to the federal Energy Information Administration and in its own audited financial statements indicates that from 2000 to 2003, LIPA's O&M costs increased by 19 percent, while its interest and PILOT payments both declined slightly.

O&M expenses are considered in terms of LIPA's costs to purchase and generate electricity (supply costs) and costs to deliver electricity. Between 2000 and 2003, LIPA's total delivery costs increased faster than its supply costs. One of the factors driving the increase in delivery cost was a 26.3 percent increase in LIPA's administrative costs, which grew faster than the amount of electricity sold by LIPA.

Industry experts at the Department of Public Service must carefully examine these trends to determine if they are reasonable, and to identify steps that might be taken to address anomalies.

What has LIPA done to mitigate cost increases, and what are the potential long-term effects of these actions?

Some steps taken by LIPA to avoid increasing costs for customers must also be recognized and considered in any rate proceedings. LIPA, by its own measure, has identified approximately \$800 million in fuel and purchased power costs it avoided passing through to ratepayers.

To a degree, the financial demands placed on LIPA and passed along to ratepayers are inescapable for an entity that inherited substantial debt

from its predecessor. LIPA has aggressively restructured its debt portfolio to take advantage of market conditions and tools that help reduce debt costs. However, LIPA's debt portfolio now includes a level of variable rate exposure that may create financial risks in the future.

Are there comparable utilities that provide lessons for LIPA in managing costs?

As a result of its geography, its history and its nature, LIPA has a different structure than most other utilities. However, other utilities—both public and private—have faced fuel price fluctuations as LIPA has. Potentially comparable electric utilities, other than Con Ed, provided electricity at a lower cost than LIPA from 1999 to 2004. In fact, two comparable utilities have seen average prices decrease during the same period LIPA's prices have increased. Industry experts should determine whether actions taken by other utilities to address fuel price fluctuations could be applied to assist LIPA in controlling costs.

A final question is more appropriately directed to LIPA's Board of Directors than the Public Service Commission: Has LIPA's Board been adequately involved in decision making as related to ratepayer costs?

In the case of major utilities operating within New York State, in addition to being subject to regulatory oversight by the PSC, each is governed by a Board of Directors. The Board, in seeking to produce the best financial result for shareholders, is expected to scrutinize the actions of management of the utility and base its decisions on a full examination of available facts. LIPA also is governed by a Board of Directors. Unfortunately, a review of Board meeting minutes indicates limited discussion of the imposition of the various surcharges and even less discussion of alternatives.

At one meeting in November 2000, a request by the Board's Deputy Chairman for an examination of the impact of rising fuel prices on LIPA's financial position seemed to be ignored with a statement from the Chairman that LIPA had a solid budget in place for 2001. LIPA's Board voted unanimously in favor of imposing the first surcharge in March 2001, two weeks after a press release first announced the plan.

The New York State Commission on Public Authority Reform is taking steps to ensure that board members are aware of their responsibilities and adequately engaged in oversight of public authority operations. The LIPA Board should take advantage of the training being offered through

EXECUTIVE SUMMARY

the Commission and should be actively involved in all rate and surcharge decisions.



Is the proposed rate increase consistent with LIPA's mission and LIPA's planned organizational structure?

The Long Island Power Authority (LIPA) is a non-profit, municipal electric utility, which owns the retail electric system on Long Island and provides electric service to nearly 1.1 million residential and commercial customers in Nassau and Suffolk counties and the Rockaway Peninsula in Queens. In 2004, LIPA sold 19.1 billion kilowatt-hours (kWh) of electricity, which generated nearly \$2.8 billion in revenues.⁵

The Long Island Power Authority Act (Act) was passed in 1986 in an attempt to control increasing electricity costs within the LILCO service area. It was believed that replacing an investor-owned utility with a publicly-owned power authority would result in safe and adequate service at lower rates, and would focus investment into more beneficial energy demand/energy supply management alternatives.⁶ According to the declaration of legislative findings accompanying the Act, ratepayers and government officials had lost confidence in LILCO's ability to supply electricity in a reliable, efficient and economic manner after the utility constructed the Shoreham Nuclear Power Plant. The Act notes that LILCO's decision to construct the Shoreham Nuclear Power Plant (at a reported cost of \$5.6 billion) created significant rate increases and a "very substantial financial strain," contributing to a situation that threatened the local economy, as well as the health and safety of people in the service area.

⁵ Energy Information Administration. U.S. Department of Energy. <<http://www.eia.doe.gov/cneaf/electricity/page/eia861.html>>.

⁶ Section 1020-a of the New York State Public Authorities Law is the declaration of legislative findings and declarations of the Long Island Power Authority Act.

IS THE PROPOSED RATE INCREASE CONSISTENT WITH
LIPA'S MISSION AND LIPA'S PLANNED
ORGANIZATIONAL STRUCTURE?

LIPA completed the takeover of LILCO in 1998. LIPA acquired LILCO's electrical transmission and distribution system, as well as certain other assets, and became the primary distributor of electricity on Long Island. The only power producing asset that LIPA owns is an 18 percent share of Nine Mile Point 2, a nuclear power plant situated near Oswego, New York on Lake Ontario.⁷ While some of the power LIPA purchases is generated using refuse, methane gas, hydropower and nuclear power, 90 percent is generated using natural gas and oil.⁸

LILCO's assets that were not acquired by LIPA, including its electric generating facilities, were merged with Brooklyn Union Gas (BUG) creating a new utility called KeySpan Corporation (also called KeySpan Energy or KeySpan). A KeySpan Corporation subsidiary, KeySpan Electric Services LLC, was created to manage electricity transmission and distribution for LIPA. KeySpan assumed operational responsibility for virtually all the plants, equipment and staff resources previously belonging to LILCO. Governed by three operating agreements, LIPA relies on KeySpan to:

- provide day-to-day management of the electricity transmission and distribution system,
- manage fuel purchases and power supply, and
- provide electricity from the Long Island-based electricity generators KeySpan acquired from LILCO.

Reducing rates in LILCO's service area was one of the Legislature's main objectives when it replaced the investor-owned utility with a publicly-owned power authority. In fact, LIPA's purchase of LILCO's securities and assets was contingent upon LIPA not increasing the "average customer rates" charged after the acquisition to a level higher than the rates projected to be charged by LILCO if the acquisition had not occurred.⁹

When LIPA took over, it promised to keep rates below the 1998 rates for at least five years. In July 1997, the Public Authorities Control Board (PACB) approved LIPA's plan to lower electric rates by an average of 17 percent (18.2 percent in Nassau County/Rockaway and 16.4 percent in Suffolk County) and by more than 20 percent over five years. The rate

⁷ Fitch Ratings. "Long Island Power Authority Ratings." August 18, 2004.

⁸ Exhibits 2-4 and 2-5 of LIPA's Energy Plan, Technical Report. June 23, 2004.

⁹ Section 1020 of the New York State Public Authorities Law is the Long Island Power Authority Act.

IS THE PROPOSED RATE INCREASE CONSISTENT WITH
LIPA'S MISSION AND LIPA'S PLANNED
ORGANIZATIONAL STRUCTURE?

reductions in each county resulted primarily from refinancing LILCO's debt, LIPA's exemption from paying federal income taxes, synergies from the merger of LILCO and BUG, and the \$1.2 billion settlement of the Shoreham tax and PILOT litigation. The total average annual rate savings over the five years was predicted to be 23.2 percent in Nassau County/Rockaway and 20.5 percent in Suffolk County. All rate savings would be spread equally over the various service classifications.¹⁰ In May 1998, Nassau County/Rockaway ratepayers saw their rates reduced by 20.9 percent, and Suffolk County residents saw their rates reduced by 19.1 percent.¹¹

LIPA's base rate has not changed since May 1998, but the average price LIPA customers pay for electricity has increased every year since 1999, LIPA's first full year of running the transmission and distribution system on Long Island.¹² While part of the price increase was due to the increase in demand during peak operating times, the major factor for the increase has been a series of increases in LIPA's Fuel and Purchased Power Cost Adjustment.

In July 2003, an editorial in *Newsday* raised questions about decisions made by LIPA's leadership and asked if the time had come to modify the public authority structure of LIPA.¹³ In April 2004, facing a March 2005 deadline for deciding whether to purchase generating capacity from KeySpan, LIPA's Chairman initiated a process to consider options for LIPA's future, including privatization. The Authority hired lawyers and finance experts to assist in the deliberations.

In the interim, in July 2004, LIPA released a draft energy plan for the years 2004 through 2013. LIPA developed a set of five strategic objectives aimed at meeting the energy needs of Long Island in a safe, reliable, and environmentally responsive manner, while maintaining competitive prices. One of these objectives calls for the minimization of rates and increased customer satisfaction. Key goals of that objective are to stabilize rates and promote economic well-being on Long Island,

¹⁰ Governor's Press Release. "Governor Delivers 20 Percent Cut in Long Island Electric Bills." March 19, 1997. In LIPA's Tariff, customers are assigned to two customer types: residential and commercial/industrial. Within customer types, rate classifications differ based on the type and timing of usage, such as water heating or space heating for residential customers and seasonal or multi-seasonal usage for commercial/industrial customers.

¹¹ Governor's Press Release. "New Era of Rate Relief Launched on Long Island." June 1, 1998.

¹² "LIPA Tariff for Electric Service." Original Leaf No. 184-185. Effective: May 29, 1998.

¹³ "LIPA's Difficult Balance: Politics and Electric Power." *Newsday*. July 6, 2003: A23.

IS THE PROPOSED RATE INCREASE CONSISTENT WITH
LIPA'S MISSION AND LIPA'S PLANNED
ORGANIZATIONAL STRUCTURE?

efficiently manage customer costs and minimize costs to the extent possible, while maintaining system reliability and customer satisfaction. Targets for those goals include minimizing retail base rate increases, ensuring LIPA's fee structure for special services recovers costs for services provided and meeting LIPA's financial target of \$20 million in net income, while passing on significant fuel savings to customers.¹⁴

It is expected that LIPA will release the results of its study on privatization and other alternatives on December 15, 2005—the new deadline for determining whether or not to purchase generating capacity from KeySpan. When the study was initiated, LIPA's Chairman said it would result in a business plan that would be subjected to public discussion to assist in making "whatever strategic decisions are necessary to have the best electric system in the country."¹⁵

The Suffolk County Long Island Power Authority Advisory Panel, established by County Executive Steve Levy, recently offered LIPA a series of recommendations relevant to the Authority's strategic organizational review. In addition to advising against the purchase of generating capacity, the Panel recommended a change in LIPA's corporate organization and greater day-to-day operational management by KeySpan in order to ensure rate stability, increased conservation and demand-side management.¹⁶

It is important that assessment of LIPA's base rates consider its original mission and potential reorganization. It is equally important that analysis by energy industry experts at the Department of Public Service is available to Long Islanders contemplating an alternative organizational structure for LIPA.

¹⁴ Long Island Power Authority. "Energy Plan 2004-2013." March 8, 2004.

¹⁵ Statement by Richard M. Kessel, Chairman, Long Island Power Authority, April 7, 2004.

¹⁶ Office of the Suffolk County Executive. Suffolk County Long Island Power Authority Advisory Panel.

Question
2

What has the effect of surcharges been on ratepayers and the Long Island economy?

Since 2001, LIPA has increased its excess fuel cost surcharge on customer bills seven times. The first, in 2001, equaled 5.8 percent; in 2003 it was raised to 8.8 percent; in 2004 it was raised three times to a total of 19.3 percent; and in 2005 it was raised twice by a total 7.4 percent. Although two of these surcharges lapsed temporarily in 2001 and 2004 when the budgets they applied to expired before a surcharge extension was approved in the subsequent year's budget, the overall increases have been permanent. However, in an effort to provide some relief to LIPA customers, LIPA's 2006 Operating Budget proposal includes a plan to reduce the Fuel and Purchased Power Cost Adjustment by 1 percent, which will save the average residential customer about \$1 per month, or \$12 per year. The reduction will become effective January 1, 2006.¹⁷

LIPA officials calculated reported surcharge percentages based on the number of months left in the year following the implementation date. When annualized for a full 12-month period, these surcharges total 34.6 percent—more than one-third an average residential customer's electric bill.¹⁸ In total, LIPA has levied surcharges that add nearly \$630 to an average residential customer's annual bill.

¹⁷ LIPA Press Release. "LIPA Proposes 2006 Operating Budget and Capital Budgets for '06 & '07." November 21, 2005.

¹⁸ Bleyer, Bill. "LIPA Boosts Surcharge." *Newsday*. October 1, 2005.

LIPA Fuel Surcharge Increases

Approval Date	Surcharge Increase	Additional Monthly Cost on Average Bill	Additional Annual Cost on Average Bill
March 2001	5.8%	\$5.33	\$63.96
March 2003	3.0%	\$9.93	\$119.16
February 2004	4.5%	\$13.22	\$158.64
June 2004	5.0%	\$21.25	\$255.00
October 2004	1.0%	\$25.24	\$302.88
June 2005	1.9%	\$28.28	\$339.36
October 2005	5.5%	\$52.46	\$629.52

Contributing to LIPA's rising fuel cost surcharges is a recent change in its accounting methodology. In February 2003, the LIPA Board approved changes in the way it recouped excess fuel and purchased power costs. Rather than continuing to spread cost recovery over several years, LIPA eliminated the lag mechanism that delayed recovery for a year or more and converted to a real-time recovery method.

In addition, LIPA established a net annual income target of \$20 million. Starting in 2004, LIPA began recovering excess fuel and purchased power costs up to the level necessary to achieve an earnings goal of \$20 million annually.¹⁹ LIPA reached its goal in 2004 and its 2005 budget projects that LIPA will hit that target again. As part of its 2006 Operating Budget proposal, LIPA announced its plan to increase its net income target to \$75 million beginning in 2006. According to LIPA, its current net income target is being increased to offset fuel price volatility and protect LIPA customers from late-year bill increases in future years.²⁰

LIPA began reporting price-related data to the Energy Information Administration (EIA) in 1999.²¹ The most recent data available is from 2004. LIPA assessed and maintained excess fuel cost surcharges

¹⁹ LIPA Minutes of the 159th Meeting held on February 10, 2004.

²⁰ LIPA Press Release. "LIPA Proposes 2006 Operating Budget and Capital Budgets for '06 & '07." November 21, 2005.

²¹ Average prices are measured in cents per kilowatt-hour (c/kWh) and are calculated by dividing total revenue recognized by LIPA on the sale of electricity in a year (measured in dollars) by the total sale of electricity during that year (measured in kilowatt-hours). Customers can calculate their monthly average electric price by dividing their total monthly bill by kWh used. Prices are an average from throughout the year because base rates are different in the summer months and at different hours of the day to account for higher demand.

beginning in March 2001. As a result of LIPA's first excess fuel cost surcharge increase in 2001 and other factors, LIPA customers paid, on average, 2.3 percent more for electricity than they did in 2000.²² LIPA's second excess fuel cost surcharge increase in 2003 drove the average price of electricity up 5.9 percent from the year before and three new surcharges in 2004 drove average prices up 10.3 percent over 2003. While LIPA did not increase its excess fuel cost surcharge in 2000 and 2002, the average price of electricity increased an average of 1.3 percent over that time, primarily a result of increased demand during peak pricing periods.

LIPA's Yearly Average Price Increases

Year	Average Price Increase
1999 to 2000	0.7%
2000 to 2001	2.3%
2001 to 2002	1.8%
2002 to 2003	5.9%
2003 to 2004	10.3%

Source: U.S. Department of Energy,
Energy Information Administration

LIPA's total revenues increased from 1999 to 2004 due to higher prices and increased demand. In 1999, LIPA collected \$2,145 million in revenues. By 2004, LIPA's revenues were approximately \$2,846 million, an increase of approximately \$701 million, or 32.7 percent, in four years.²³ In 2003 and 2004, LIPA's revenues rose more than 11 percent each year.

²² LIPA and other electric utilities are required to report revenue and sales statistics to the U.S. Department of Energy's Energy Information Administration (EIA). Section 13 (b) Public Law 93-275 authorizes the EIA to collect the information from all persons owning or operating facilities or business premises who are engaged in any phase of energy supply or major energy consumption, and to require full identification of all data and projections as to source, time and methodology of development. Data is also gleaned from annual audited financial statements, budgets and other financial documents.

²³ Energy Information Administration. U.S. Department of Energy. <<http://www.eia.doe.gov/cneaf/electricity/page/data.html>>.

LIPA's Annual Revenues
(thousands of dollars)

Year	Revenues
1999	\$2,144,833
2000	\$2,173,820
2001	\$2,201,692
2002	\$2,286,450
2003	\$2,543,894
2004	\$2,846,007

Source: U.S. Department of Energy,
Energy Information Administration

When LIPA cut electric rates on Long Island in 1998, Governor Pataki announced that the “average Long Island homeowner would save about \$250 annually” and all households combined would save \$240 million.²⁴ A 2003 economic impact study on LIPA’s base rate cut estimated that each dollar added to a Long Island household’s disposable income “turns over at least five times a year” to help stimulate the regional economy.²⁵ The study estimated that “the \$2.5 billion that LIPA has injected into the Long Island economy through rebates and rate reductions during its five-year existence has expanded the region’s economy by some \$12 billion.”²⁶ While the base electric rate cuts trumpeted by Governor Pataki and LIPA had a positive impact on household discretionary spending and the local economy, their announcements made after 2001 neglected to mention the negative impact the surcharges had on the average household and the Long Island economy.

Effective October 8, 2005, the excess fuel cost surcharge increased average annual residential customer bills \$630, or 34.6 percent. The surcharge costs all residential ratepayers over \$600 million per year. While an economic analysis of the impact of LIPA’s surcharge is outside the scope of this paper, for comparison purposes with the earlier analysis, the multiplier provided in Dr. Kellner’s study will be used.

²⁴ Pataki, Governor George E. “Governor Pataki: New Era of Rate Relief Launched on Long Island.” June 1, 1998.

²⁵ Kellner, Dr. Irwin. “Economic Benefits of LIPA’s Rate Cut for Long Island.” 2003.

²⁶ *Ibid.*

WHAT HAS THE EFFECT OF SURCHARGES BEEN
ON RATEPAYERS AND THE LONG ISLAND
ECONOMY?

When applying his multiplier, LIPA's surcharge on residential households could have an annual negative impact on Long Island's economy of as much as \$3 billion in 2006. Should LIPA's proposed 1 percent surcharge decrease go into effect on January 1, 2006, the change in the annual negative impact on the Long Island economy will be negligible.

In the commercial and industrial sectors, manufacturing represents some of the most energy intensive industries. Long Island has seen its manufacturing base decline due, in part, to historically high energy costs. A June 2005 study by The Boyd Co., a Princeton, New Jersey-based consulting firm, explored the economic impacts associated with opening a plastics factory on Long Island. Among the disadvantages, the study found that Long Island would have the eleventh highest operating costs among 125 sites nationwide and identified energy costs as a major cause. Upon the report's release, the President of the Long Island Forum for Technology indicated that manufacturers of high-volume, low cost items have either left or never located within the Long Island region due to high operating costs.²⁷

Rates and decisions about LIPA's organizational structure must consider the potential impact on both residential and commercial ratepayers and the Long Island economy.

²⁷ Schachter, Ken. "Comparative Cost Study Advises Against Starting a Plastics Factory on Long Island." *ProQuest Information and Learning Company and Dolan Media Newswires*. *Long Island Business News*. June 17, 2005.

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?



Were surcharges lawful and appropriate, and is LIPA's calculation of Fuel and Purchased Power, used to justify surcharges, reasonable?

The PACB, which was created in 1976 in response to the growing amount of public authority debt, oversees financing activities of eleven statewide public authorities, including LIPA. These authorities must receive a resolution of approval from the PACB prior to entering into any project-related financings. As part of the approval of the LIPA-LILCO merger, the PACB passed a resolution that, among other things, put constraints on LIPA's ratemaking.

The resolution prohibits LIPA from implementing an "increase in average customer rates exceeding 2.5 percent over a 12-month period" or an extension or reestablishment of "any portion of a temporary rate increase over 2.5 percent, without approval of the Public Service Commission following a full evidentiary hearing."²⁸ The resolution also requires LIPA to "guarantee that, over a ten-year period commencing on the date when LIPA begins providing electricity service, average rates within the LIPA service territory will be reduced by no less than 14 percent when measured against LILCO's base rates."²⁹ The 14 percent average rate "may be adjusted to reflect emergency conditions and extraordinary unforeseeable events including a precipitous rise in oil prices."³⁰

LIPA's rates are specified in its Tariff for Electric Service (Tariff). The Tariff cites LIPA's legal authority to set rates as deriving from the Public

²⁸ PACB Resolution 97-LI-1, "Approving Certain Specified Projects of the Long Island Power Authority, Project Identification, Project Condition #5," July 16, 1997.

²⁹ *Ibid.*

³⁰ *Ibid.*

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

Authorities Law and states that “any provisions of this Tariff may be modified, at any time, upon approval of the Authority’s Trustees”.³¹

In the Tariff, customers are assigned to specific service and rate classifications based on factors that include usage, demand, voltage and purpose. Each classification specifies who is eligible, the character of the service and the rates. Rates are generally specified for two periods—June through September, and the rest of the year—with rates generally set higher during the June through September period to reflect increased demand during the summer months. In addition, other special circumstances and miscellaneous charges are specified throughout the Tariff, such as charges for reconnection after termination of service, penalty charges for late payment, pole attachment charges and no-access charges.

Within the rate specifications for each customer class, there is an “adjustment-to-rates” clause that specifies that each customer’s bill will be adjusted for one or more categories of adjustment.³² The following categories are included:

- Fuel and Purchased Power Cost Adjustment (fuel cost surcharge),
- Adjustment to Rates and Charges to Recover Payment in Lieu of Taxes (PILOT) payments,
- Ratepayer Class Action Refund Rider,
- Shoreham Property Tax Settlement Rider, and
- Adjustment to Rates to Encourage Business Development.

LIPA relies on purchased fuel and power to provide electricity to its customers and uses fuel cost surcharges to recoup excess fuel and purchased power costs that exceed budget estimates. LIPA’s Tariff allows it to pass through up to 100 percent of certain fuel costs according to a predetermined formula outlined in the Tariff. LIPA has modified its Tariff periodically, often expanding the Fuel and Purchased Power Cost Adjustment section.

³¹ Chapter V, Title 1-A of the LIPA Tariff, p. 25.

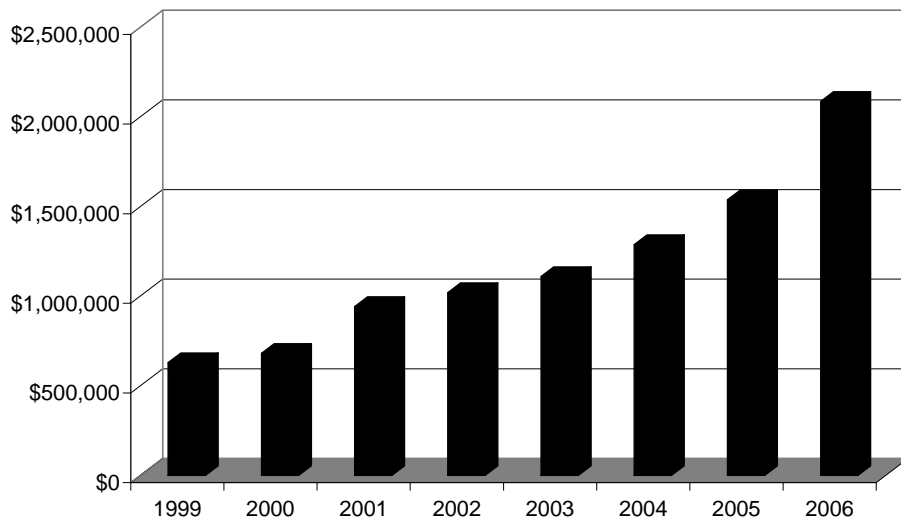
³² Chapter VIII of the LIPA Tariff.

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

Nearly all of LIPA's electricity is generated by outside entities, such as KeySpan, and sold to LIPA through power purchase agreements.³³ Consequently, the fuel costs incurred by those companies are passed on to LIPA. Nearly all of the power purchased from KeySpan is generated using oil and natural gas. As expected, recent increases in oil and natural gas prices have increased LIPA's costs significantly.

Between 1999 and 2006, LIPA increased the amount budgeted for fuel and purchased power by \$1,457 million, or 231.6 percent. For fiscal year 2006, LIPA's proposed budget includes \$2,086 million for fuel and purchased power, an increase of 35.7 percent over 2005 and more than triple the \$629 million that was budgeted in 1999 (see Appendix A).³⁴

Fuel and Purchased Power Costs (thousands of dollars)



New York State Public Service Law provides guidance on what types of costs can be recovered using a fuel cost surcharge. Allowable costs are generally limited to the cost of fuel and purchased power, and fees paid to brokers involved in fuel purchases.³⁵ Although LIPA may not be bound by these requirements, they are considered an accepted industry

³³ As part of the dismantling of LILCO, LIPA assumed LILCO's 18 percent share of the Nine Mile Point 2 nuclear facility. This is the only generation capacity owned by LIPA.

³⁴ LIPA's 1999 through 2005 Approved Budgets and 2006 Proposed Budget. <<http://www.lipower.org>>.

³⁵ 16 NYCRR, Section 720-6.2.

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

standard and serve as a good example of what other utilities are able to recover from ratepayers without PSC approval.

The EIA also defines fuel expenses and purchased power costs. Fuel expenses are costs of any material substance used to supply power, including the costs to get shipped fuel to the power plant. Purchased power is power purchased or available for purchase outside the electric system.³⁶

When compared to the Public Service Law and EIA definitions, LIPA's definition of which costs can be recovered with a fuel cost adjustment is broader. LIPA's tariff, modified in February 2002, includes the following categories in its fuel and purchased power cost definition:

- The total actual cost of fossil and nuclear fuel purchased on behalf of the Authority to produce electricity, plus
- The total actual cost of all electric power purchased by or on behalf of the Authority from the New York Power Authority (NYPA), other utilities and independent power producers, including qualifying facilities, plus
- The total actual cost of all transmission wheeling charges related to above bullet (including charges on the NYPA-built 345 KV interconnection Circuit No. Y49 from Sprain Brook, New York, to East Garden City, New York and any additional off-island transmission facilities which are constructed and deliver power to the Authority's system), plus
- The total actual cost of payments by the Authority to customers who shed load during times of high system demands at the request of the Authority, minus
- The actual fuel costs and the value of foregone emissions credits related to energy sold to other utilities, power marketers or other brokers who are not agents for retail power supply customers of the Authority, plus
- The Fuel Purchase Performance Incentive in accordance with the Energy Management Agreement, plus

³⁶ The EIA prescribes a uniform system of accounting for public utilities subject to the Federal Power Act.

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

- Charges for Scheduling, System Control and Dispatch Service (cost based components of ancillary services) provided by the New York Independent System Operator (NYISO) in accordance with Schedule 1 of the NYISO Open Access Transmission Tariff, plus
- Any other net charges or revenues associated with TCC's ancillary services and short-term capacity revenues received by LIPA as a participant in the NYISO, plus
- Bill Credit Adjustment (BCA) revenues received by the Energy Service Company's (ESCO's) and Direct Retail Customers (DRCs) under the Long Island Choice Program, discounted by the Factor of Adjustment.³⁷

The items approved for inclusion in LIPA's budgeted fuel and purchased power cost have been modified more recently. A comparison of the Public Service Law and LIPA's budgeted fuel and purchased power costs reveals that LIPA's list includes many more items.

³⁷ Long Island Power Authority, Tariff For Electric Service, Fourth Revised Leaf No. 166.

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

Fuel and Purchased Power Cost Definition – LIPA vs. NYCRR

NYCRR – Cost of Fuel	LIPA's 2006 Budgeted Fuel and Purchased Power Costs
Cost of Fossil Fuel	Fuel Oil and Natural Gas
Cost of Hydro	None
Cost of Nuclear Fuel	Nuclear Fuel
Cost of Economy Energy Purchased	Purchased Power
Fuel Cost of Other Energy Purchased	Purchased Power
Adjustments for Energy Purchased Cost Estimation	Purchased Power
None	Wheeling and Capacity Charges
None	Nine Mile Wheeling Charges
None	Y-49 and Y-50 Cable Operating Costs
None	Fuel Hedging Program Costs
None	Fuel Hedging Program Financial Statements
None	Emissions Allowances Purchases
None	ESCO Bill Credit Adjustment Payments
None	Ancillary Service Revenues - Net
None	Energy Management Agreement
None	Independent System Operator-Related Service Costs
None	NYPA Transmission Adjustment Charge
None	Cost of Off-System Sales
None	Barge Lease and Transportation Costs
None	Clean Energy Peak Load Reduction Rebates
None	Payments Under RPS Program
None	Recovery of Deferred Fuel and Purchased Power Costs
None	Other-One-Time Adjustments

Source: 16 NYCRR Section 720-6.2 and LIPA's 2006 Proposed Budget

An analysis of LIPA's approved budgeted fuel and purchased power costs reveals that there is more contributing to high costs than purchased power alone. Some of the additional cost between 2000 and 2005 can be attributed to the expanded list of costs included in the fuel and purchased power costs budget category. In 1999, LIPA included six cost categories in fuel and purchased power. Over time, LIPA added, deleted and combined the costs in the grouping, ultimately including 19 costs in its 2006 proposed fuel and purchased power costs. Among those added is ESCO Bill Credit Adjustment Payments, which accounts for 5 percent of total 2006 fuel and purchased power costs (see Appendix A). Other costs newly attributed to fuel and purchased power include: fuel hedging program costs, emissions allowance purchases, Energy Management Agreement, Independent System

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

Operator (ISO)-Related Service Costs, NYPA Transmission Adjustment Charge, Cost of Off-System Sales, Barge Lease and Transportation Costs, Clean Energy Peak Load Reduction Rebates, Recovery of Deferred Fuel and Purchased Power Costs, and Other-One-Time Adjustments.³⁸ Cumulatively, costs added to the definition have increased LIPA's budgeted fuel and purchased power costs by more than \$311 million.

Costs for New Supply

Increased demand has also increased costs for LIPA. Chairman Kessel has stated that “the surcharge amount is driven not just by higher oil and natural gas prices, but also by the need to increase the infrastructure on Long Island for power purchases in order to meet the growing demand.”³⁹

According to LIPA, the average household electricity use on Long Island has increased by 15 percent over the last six years, making the residents and businesses of Long Island the nation's fourth highest average users of electricity. Despite rising costs and conservation efforts, increases in power usage are expected to continue.⁴⁰ Given this prediction, LIPA has taken steps to increase energy supply and reduce demand.

When the Shoreham Nuclear Power Plant failed to come on line, Long Island was faced with a shortage of power generation capabilities.

In 2001, LIPA came close to using its entire power supply. In response, LIPA began a campaign to increase the energy supply to Long Island through the addition of energy generating plants. Since 2001, LIPA has contracted with private companies who agreed to build and operate 11 generation facilities, all of which fall below the 80-megawatt size limit requiring PSC approval. In exchange, LIPA agreed to purchase the approximately 622 megawatts of power they generate.⁴¹ In addition to buying power from these plants, LIPA also began renting diesel-fueled mobile generators for periods of peak demand.

³⁸ LIPA and Subsidiaries. Proposed Operating Budget – 2006.

³⁹ LIPA Board of Trustee Meeting Minutes. December 20, 2002.

⁴⁰ LIPA Press Release. "LIPA Projects Sufficient Electricity Supply for Summer 2005." June 22, 2005.

⁴¹ *Ibid.*

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

According to records maintained by the Comptroller's Contracts Unit, as of October 2005, LIPA had entered into active contracts with several independent power producers, other than KeySpan, worth more than \$1 billion. In addition, LIPA had entered into active contracts for temporary generators worth approximately \$52 million, including diesel-powered mobile generators located in various places around Long Island.

LIPA has also actively sought out other sources of energy. In June 2004, the cross Long Island Sound cable came on line providing LIPA with up to an additional 330 megawatts of power from Connecticut. That same year, LIPA announced its plan to spend about \$200 million per year to develop and build additional energy supply options including renewable energy sources. Among the projects announced were:

- A 660 megawatt undersea cable connecting Long Island and New Jersey,
- A 39-windmill, 140 megawatt wind farm off the south shore of Long Island,
- A 326-megawatt gas powered plant to be built in South Yaphank,
- A 79.9 megawatt combined cycle power plant to be built in Bethpage, and
- A 79.9 megawatt combined cycle power plant to be built in West Babylon.⁴²

In addition, as part of a longer-term strategy to meet Long Island's ever-growing demand for electricity beyond 2013, and to further reduce its reliance on fossil fuels, LIPA is reviewing the potential for another major cable link to the Mid-Atlantic States. This would be in addition to the 330 MW cross-Sound cable that is in operation now and the 660 MW Neptune cable that is due in service in 2007.⁴³

As part of its deliberations, the PSC must determine if costs associated with long-term power purchase agreements are recoverable through surcharge or, whether once they become predictable, they must be part

⁴² McGinty, Tom. "LIPA Reveals Cost of Energy Plans." *Newsday*. May 27, 2004.

⁴³ LIPA Press Release. "Kessel Announces Plan to Increase LIPA's Energy Efficiency Efforts & Hold Out Possibility of Adding Third New Cable Link to LI by 2013." July 28, 2005.

WERE SURCHARGES LAWFUL AND APPROPRIATE,
AND IS LIPA'S CALCULATION OF FUEL AND
PURCHASED POWER, USED TO JUSTIFY
SURCHARGES, REASONABLE?

of the base rate. Better definition of acceptable Fuel and Purchase Power categories is essential since, even if it is granted a base rate increase, LIPA will likely be able to continue to impose surcharges, as are other utilities.



Does LIPA need to make improvements to cost estimates?

The future of oil and gas prices is unpredictable. Oil and gas analysts did not predict that natural gas and oil prices would reach \$15 per million British thermal unit (MMBtu) and \$70 a barrel in 2005, respectively.⁴⁴ Given the anticipated growth in foreign demand and continued limited production, climbing oil prices should remain a long-term concern for utilities such as LIPA.

In light of that concern, LIPA contracted with PACE Global Energy Services (PACE) for energy risk advisor services for a four-year period at an estimated cost of \$500,000 per year. Under this contract, LIPA asked PACE to prepare a report with strategic guidance for hedging its fuel purchases against future market fluctuations.⁴⁵ Released in April 2005, the report provided a comprehensive history of energy prices and numerous assumptions about future prices, including that “high energy prices are here to stay.”⁴⁶ However, the publicized report did not include specific strategies or recommendations to LIPA for minimizing the impact of these high prices on LIPA’s customers.

In its 2006 approved operating budget, LIPA predicted that by 2010, fuel and purchased power, one of LIPA’s largest expenditures, will decrease by \$166 million, to \$1,920 million, while revenues will decrease by \$70 million to \$3,665 million.⁴⁷ At the same time, LIPA predicts that its fuel

⁴⁴ NYMEX Henry-hub Natural Gas Closing Price. August 10, 2005. <<http://www.oilenergy.com>>; U.S. Executive Summary. July 2005. Global Insight website. <<http://www.globalinsight.com>>.

⁴⁵ LIPA Minutes of the 161st Meeting held on May 26, 2004.

⁴⁶ *A Discussion on Sustained Advances in Energy Prices*. Prepared for Long Island Power Authority. Global Energy Services. April 20, 2005.

⁴⁷ LIPA Approved Operation Budget – 2006, Statements of Revenues and Expenses.

and purchased power surcharge fee will also decrease.⁴⁸ Although not specified, it appears that LIPA plans to reduce its fuel and purchased power cost surcharge in proportion to the anticipated decrease in fuel costs; however, if fuel costs do not drop, LIPA will need to make up the reduction in the surcharge through some other means—possibly by increasing rates.

In the two years since LIPA began publicizing its forecasts, LIPA's surcharge predictions have not accurately reflected actual changes in its surcharge rates. According to LIPA's 2004 Approved Operating Budget, LIPA expected the 2004 surcharge to equal 13.3 percent. In actuality, three increases during 2004 raised LIPA's surcharge to 19.3 percent.⁴⁹ Similarly, for 2005, LIPA estimated that the surcharge would increase by 1.4 percent to 14.7 percent.⁵⁰ As of November 2005, LIPA had already increased the surcharge by 7.4 percent to 26.7 percent, which equates to an annualized surcharge of 34.6 percent.

Energy industry experts at the Department of Public Service should advise LIPA about ways it might strengthen its estimates and improve price predictability for its ratepayers.

⁴⁸ *Ibid.*

⁴⁹ LIPA and Subsidiaries. Approved Operating Budget – 2004.

⁵⁰ LIPA and Subsidiaries. Approved Operating Budget – 2005.

Question
5

What costs have grown in LIPA's budget, and what are the opportunities to control costs?

LIPA began reporting cost-related data to the EIA in 2000. The most recent data available is from 2003. LIPA expends its revenues in three primary areas: operations and maintenance (O&M) costs, debt service costs, and payments in lieu of taxes (PILOTs) and other tax payments. According to LIPA, 2003 O&M expenses consumed approximately 77.7 percent of a LIPA customer's bill, while PILOT/tax payments were approximately 13.4 percent and interest charges accounted for approximately 8.9 percent of those bills.⁵¹

LIPA's Expenses – 2000 and 2003
(millions of dollars)

Expense	2000	2003	% Change
<i>Operations and Maintenance</i>	\$1,556	\$1,855	19.2%
Supply	\$1,215	\$1,439	18.4%
Delivery	\$340	\$416	22.4%
General & Admin	\$175	\$221	26.3%
<i>Interest Charges</i>	\$344	\$319	(7.3)%
<i>PILOTs</i>	\$230	\$213	(7.4)%
Total	\$2,130	\$2,387	12.1%

Source: U.S. Department of Energy, Energy Information Administration and LIPA's Audited Financial Statements

LIPA's annual operating budget presents a different breakdown of expenses and their change over time (see Appendix B). The largest expense in LIPA's proposed 2006 budget, fuel and purchased power

⁵¹ Energy Information Administration. U.S. Department of Energy. <<http://www.eia.doe.gov/cneaf/electricity/page/data.html>>.

costs, is approximately 56.1 percent of total budgeted expenses. Other expenses in LIPA's proposed 2006 budget include O&M costs, which are a portion of the total O&M costs reported to the EIA (20.5 percent), interest expense (9.3 percent), depreciation and amortization (6.6 percent), PILOT/tax payments (6.3 percent), and general and administrative expenses (1.3 percent).⁵² The following analysis is based on data submitted by LIPA to the EIA.

Operations and Maintenance Expenses

LIPA's O&M expenses consist of electricity supply and delivery costs, including administrative costs to oversee operations and the cost to generate nuclear power (Nine Mile Point 2), purchase power on the open market, transmit electricity to substations, and distribute electricity to homes and businesses. In 2000, LIPA's O&M expenses totaled approximately \$1,556 million. By 2003, LIPA's total O&M expenses were approximately \$1,855 million, a \$299 million, or 19.2 percent, increase (see preceding table).⁵³ LIPA's O&M expenses per kWh sold increased 12.4 percent from 2000 to 2003.⁵⁴ However, O&M expenses per kWh sold decreased 1.6 percent in 2003, while its average electric prices increased 5.3 percent. In summary, LIPA sold more electricity at a higher price to customers in 2003 despite lower per unit O&M costs.

Supply Costs

LIPA's total supply costs (purchased and generated electricity), a portion of overall O&M expenses, increased between 2000 and 2003. However, LIPA realized a decrease in the supply cost per kWh in 2003, which was not reflected in LIPA's price. Between 2000 and 2003, LIPA's cost to purchase electricity for its customers increased from \$1,215 million to \$1,439 million, an increase of \$224 million or 18.4 percent. When measured in cents per kWh (c/kWh), LIPA's supply costs increased from 6.85 c/kWh to 7.67 c/kWh from 2000 to 2002, an 11.9 percent increase. By 2003, the cost per kWh decreased to 7.64 c/kWh, but still made up nearly half of LIPA's average electricity price per kilowatt hour.⁵⁵ Despite the decrease in supply costs per kWh in

⁵² LIPA's 2006 Proposed Operating Budget.

⁵³ Energy Information Administration. U.S. Department of Energy. <<http://www.eia.doe.gov/cneaf/electricity/page/data.html>>.

⁵⁴ O&M expenses per kWh are calculated by dividing kWh sold by total O&M expenses.

⁵⁵ Energy Information Administration. U.S. Department of Energy. <<http://www.eia.doe.gov/cneaf/electricity/page/data.html>>.

WHAT COSTS HAVE GROWN IN LIPA'S BUDGET,
AND WHAT ARE THE OPPORTUNITIES TO
CONTROL COSTS?

2003, LIPA implemented a 3 percent excess fuel cost surcharge during that year, a move it attributed to increasing fuel and purchased power Costs in 2002 and its new policy of collecting projected fuel cost overruns and a \$20 million net income target.

Delivery Expenses

Between 2000 and 2003, LIPA's total delivery expenses increased faster than supply costs. In 2000, LIPA's delivery costs were \$340 million. By 2003, LIPA's delivery costs had increased to \$416 million, an increase of \$76 million, or 22.4 percent. The cost to deliver electricity measured in c/kWh mirrored the trajectory of supply and overall O&M expenses. From 2000 to 2002, LIPA's delivery costs per kWh increased from 1.91 c/kWh to 2.34 c/kWh, an increase of 22.2 percent. From 2002 to 2003 LIPA's delivery costs per kWh decreased to 2.21 c/kWh.

In 2000, general and administrative costs accounted for 51.5 percent of LIPA's delivery costs and totaled \$175 million.⁵⁶ By 2003, LIPA's general and administrative costs were \$221 million, an increase of 26.3 percent, making the general and administrative costs total 53.1 percent of delivery costs. Between 2000 and 2003, LIPA's general and administrative costs increased faster than the number of kWh of electricity sold, from .99 c/kWh to 1.18 c/kWh, an increase of 19.2 percent.⁵⁷

A January 2004 report by the Office of the State Comptroller on LIPA's budget procedures showed that the total number of LIPA staff increased from 47 in December 1999 to 79 in December 2002, an increase of 32 employees, or 68 percent. Since December 2002, the number of LIPA employees has continued to rise. According to LIPA's response to the Comptroller's Annual Public Authority Data Request, LIPA's staff increased from 79 employees in December 2002 to 96 employees in December 2004, an increase of 17 employees, or 22 percent.

⁵⁶ Administrative and general expenses include a broad array of expenses that are not directly attributable to supply, transmission or distribution, but support those activities, including:

- office supplies and expenses, property insurance, and general advertising expenses,
- employee pensions and benefits, outside services employed, and injuries and damages,
- franchise requirements and regulatory commission expenses, and
- rents, non-major transportation expenses, and maintenance of general plant.

Source: EIA

⁵⁷ LIPA. "Long Island Power Authority Energy Plan: 2004-2013."

WHAT COSTS HAVE GROWN IN LIPA'S BUDGET,
AND WHAT ARE THE OPPORTUNITIES TO
CONTROL COSTS?

In addition, the previous report discussed LIPA's practice of hiring numerous consultants for assistance with engineering, legal, financial, marketing, personnel and government relations activities. An analysis of LIPA's approved 1999 and proposed 2006 budgets reveals that its consultant costs have increased from \$12.1 million in 1999 to \$24.5 million in 2006, an increase of \$12.4 million, or 102 percent.

In a June 4, 2004 press release announcing an additional 5 percent fuel surcharge, Chairman Kessel stated that LIPA will "continue to squeeze every dollar...out of our budgets to help offset some of the increased fuel-related costs."⁵⁸ Although LIPA states that it uses the revenue generated from its excess fuel cost surcharge to pay for increasing fuel and purchased power costs (supply costs), there is some question about whether those funds have been used to supplant funds that were used to pay for rising delivery costs, specifically general and administrative costs, instead.

The costs LIPA has incurred to promote its Clean Energy Initiative (CEI) are also included in delivery costs. LIPA should be commended for its CEI efforts. However, at \$355 million over ten years, CEI costs place pressure on electricity prices.⁵⁹ Delivery cost efficiencies must be realized elsewhere to ensure that increasing supply and CEI costs do not combine to put pressure on LIPA's rates.

Interest Charges

LIPA currently has more debt than it started out with.⁶⁰ However, interest charges decreased between 1999 and 2004, despite increasing average outstanding debt levels, as interest rates have fallen on LIPA's variable rate debt. Based on LIPA's audited financial statements, interest charges have decreased 6.5 percent from \$339 million in 1999 to \$317 million 2004.⁶¹ However, as interest rates rose in the first nine

⁵⁸ LIPA Press Release. "Due to Higher Fuel Costs LIPA Announces 5% Addition to Existing Surcharge." June 4, 2004.

⁵⁹ LIPA's website. <<http://www.lipower.org/cei/cei.html>>.

⁶⁰ Office of the Suffolk County Executive. Suffolk County Long Island Power Authority Advisory Panel Recommendations on Strategic Re-Organization Plans. November 19, 2005.

⁶¹ Full year, audited financial statements are available for LIPA from 1999 to 2004. Interest charges in 2000 and 2003 were presented in the preceding table for comparison purposes.

WHAT COSTS HAVE GROWN IN LIPA'S BUDGET,
AND WHAT ARE THE OPPORTUNITIES TO
CONTROL COSTS?

months of 2005, LIPA saw interest charges increase \$10.7 million compared to the first nine months of 2004.⁶²

PILOT and Tax Payments

LIPA is required to make PILOT payments for all operating taxes previously paid by LILCO, including gross income, gross earnings, property, Metropolitan Transportation Authority and certain taxes related to fuels used in utility operations. In addition, LIPA has entered into various PILOT arrangements for property it owns, upon which merchant generation and transmission is built.⁶³ While LIPA customers have seen their average electricity prices rise from 2000 to 2003, LIPA's PILOT and tax payments have steadily decreased. In 2000, LIPA paid \$230 million in PILOT and taxes. By 2003, LIPA paid \$213 million, a decrease of \$17 million, or 7.4 percent. Payments decreased because LIPA made its final PILOT related payments on the Shoreham Nuclear Power Facility property in 2002 and earning's tax rates declined in 2003. LIPA realized an increase in PILOT and tax payments in 2004 of less than \$2 million.⁶⁴

Various budget trends should be analyzed in conjunction with the review of LIPA's rates. It is important to identify opportunities to reduce costs that can be controlled in order to minimize the impact on ratepayers of increasing costs over which LIPA has no control.

⁶² LIPA's Third Quarter Financial Statements, Unaudited.

⁶³ LIPA's 2004 Audited Financial Statements, Note 3(r).

⁶⁴ LIPA's 2002 and 2003 Audited Financial Statements, Management's Discussion and Analysis.



What has LIPA done to mitigate cost increases, and what are the potential long-term effects of these actions?

LIPA’s Tariff allows LIPA to pass on 100 percent of its fuel costs to ratepayers. To minimize the full impact of Fuel and Purchased Power Cost Adjustments on LIPA customers, LIPA has implemented mitigation efforts, including restructuring its debt repayment schedules, reducing budgeted costs and utilizing fuel hedging programs. These efforts have enabled LIPA, by its own estimate, to “absorb approximately \$800 million in fuel costs since 1998.”⁶⁵

LIPA's Absorption and Pass Through of Additional Fuel Costs 2000 through September 2005
(millions of dollars)

Year	Additional Fuel Cost	Total Absorbed	Total Passed on to Customers
2000	\$307	\$181	\$126
2001	\$200	\$75	\$125
2002	\$254	\$125	\$129
2003	\$626	\$159	\$467
2004	\$501*	\$110	\$391*
2005	\$683*	\$150	\$533*
Total	\$2,571	\$800	\$1,771

Source: LIPA Press Releases

*State Comptroller estimates based on information available in LIPA press releases.

⁶⁵ LIPA Press Release. "Surging Fuel Prices Require LIPA to Add 5.5% to Electric Bills to Cover a Portion of Higher Costs." September 30, 2005.

WHAT HAS LIPA DONE TO MITIGATE COST INCREASES, AND WHAT ARE THE POTENTIAL LONG-TERM EFFECTS OF THESE ACTIONS?

LIPA also has initiated an aggressive debt management strategy in an effort to control costs. Specifically, the Authority has utilized variable rate debt to lower its operating costs. However, variable rate debt has also introduced the risk that future interest rate fluctuations could adversely impact LIPA's base rates and, therefore, the price of electricity in LIPA's service area. With interest rates rising, LIPA has been forced to address the risks borne by utilizing a significant amount of variable rate debt.

LIPA's debt management policy has evolved over the past two years to address the risks inherent in its variable rate debt portfolio. Its aggressive pursuit of lower short-term interest costs has been tempered with more prudent consideration of long-term interest costs. LIPA has also entered into derivative transactions to manage interest rate risk and also, at times, increased its exposure to variable rate debt obligations—which carry their own risks. To mitigate the effects of those transactions, LIPA has entered into Interest Rate Exchange Agreements (swaps).⁶⁶ LIPA has used both variable-to-fixed and fixed-to-floating swaps. The following table shows LIPA's exposure as of June 30, 2005 to variable rate obligations and the effect of interest rate hedging transactions:

**LIPA Variable Rate Exposure as a Percent of Total Debt
June 30, 2005**
(thousands of dollars)

Measurement	Debt	% of Total Debt
Gross Debt	\$7,184,134	100%
Gross Variable Rate Debt	2,162,225	30%
Variable Rate Swapped to Fixed Rate	953,225	13%
Fixed Rate Swapped to Variable Rate	317,990	4%
Net Variable Rate Exposure	1,526,990	21%

Source: November 3, 2005 LIPA Swap Report

Note: Gross variable rate debt includes bonds and commercial paper, and excludes capital lease obligations. Also, LIPA entered into a basis swap on approximately \$1 billion of its variable rate debt which remains in a variable rate mode.

⁶⁶ An interest rate exchange agreement (swap) is a contractual agreement between two parties who agree to exchange certain cash flows for defined period of time. Generally, the cash flows to be swapped relate to interest to be paid or received with respect to some asset or liability; however, there is no principal exchanged in a swap, only interest payments based on the size of the swap. *New York State's Debt Policy, A Need for Reform*. Alan G. Hevesi. New York State Comptroller, February 2005.

WHAT HAS LIPA DONE TO MITIGATE COST INCREASES, AND WHAT ARE THE POTENTIAL LONG-TERM EFFECTS OF THESE ACTIONS?

On June 30, 2005, LIPA's gross variable rate debt and net variable-rate exposure percentages were 30 and 21 percent, respectively.⁶⁷ Bond rating firms generally evaluate exposure to variable interest rates and financial derivatives, such as swaps, on a case-by-case basis.⁶⁸ Moody's continues to view LIPA's net variable rate exposure as a risk/weakness.⁶⁹

Standard & Poor's has noted the risks assumed when a municipal utility adopts an aggressive debt policy are ultimately borne by its ratepayers, unlike in a private utility where they are borne by its shareholders.⁷⁰

LIPA also is attempting to mitigate price increases by reducing consumption. In July 2005, Chairman Kessel announced plans to increase spending on LIPA's Clean Energy Initiative by at least \$15 million in 2006. Continued emphasis over increased efficiency and decreased consumption is essential to control prices for ratepayers.

LIPA deserves credit for the steps it has taken to mitigate cost increases for ratepayers. Some of LIPA's actions, however, create financial risks for the future that must be factored into rate setting.

⁶⁷ Includes commercial paper and capital leases in total debt position.

⁶⁸ Factors considered when determining an issuer's capacity for interest rate swaps and variable rate exposure may include the issuer's operating flexibility, debt levels, access to capital, financial management capabilities, and potential for collateral calls and termination payments.

⁶⁹ Moody's Investors Service. "Rating Update: Long Island Power Authority, NY." November 22, 2005.

⁷⁰ Standard & Poor's. "Public Finance Criteria 2003: General Government Utilities – Electric Utilities Ratings." p. 103.



Are there comparable utilities that provide lessons for LIPA in managing costs?

LIPA's average electric prices are higher than the national average, State average and nearly all of the largest electric utilities in the nation. In 1999, LIPA's average electric price of 12.16 c/kWh was 83 percent higher than the national average of 6.64 c/kWh. In 2004, LIPA's average price of 14.90 c/kWh was 96 percent higher than the national average of 7.62 c/kWh. Also in 2004, New York State residents and businesses paid an average of 12.55 c/kWh. Although New York State's average electricity price was the second highest in the nation, LIPA's 2004 average price was 18.7 percent higher. Furthermore, compared to 200 of the more than 3,000 electric utilities in the United States with the most customers in 2004, LIPA's price of 14.90 c/kWh was the third highest in the nation.⁷¹

LIPA is the second largest publicly-owned electric utility in the nation when measured by number of customers and the largest when measured by revenue.⁷² Comparing the price LIPA charges for electricity to national and state averages establishes a benchmark, but its history, structure and geography are different than electric utilities of average size and location.

Few publicly-owned electric utilities in the United States operate on the same scale and over the same type of geography as LIPA. However, there are several investor-owned electric utilities in New York City, New

⁷¹ Energy Information Administration. Electric Power Annual 2004. Washington, DC: Energy Information Administration. <<http://www.eia.doe.gov/cneaf/electricity/epa/epa.pdf>> and EIA Form 412 data; prices are based on total revenues and kWh sold. Prices included in this report are not broken down by type of customer (residential, commercial, industrial, etc.).

⁷² Energy Information Administration.
<<http://www.eia.doe.gov/cneaf/electricity/page/data.html>>.

ARE THERE COMPARABLE UTILITIES THAT
PROVIDE LESSONS FOR LIPA IN MANAGING
COSTS?

Jersey and Connecticut that have faced, and continue to face, similar supply and delivery cost pressures that make for a more accurate price and expense comparison. The challenges LIPA is facing are exposed through this comparison, as are opportunities for lower electric prices in LIPA's service area.

The criteria used when selecting electric utilities for comparison with LIPA included, but were not limited to: geography, number of customers, type of customers, power pool participation, generation source, kWh demanded per customer, type of ownership, and regulation (see table of comparable electric utilities in Appendix C). The Los Angeles Department of Water & Power (City of Los Angeles) has more customers than any other publicly-owned electric utility in the nation and is the only other publicly-owned electric utility included in our comparison group. It is comparable to LIPA because it is a publicly-owned utility, serves a large metropolitan area, delivers a similar amount of electricity to each of its customers and has a similar mix of customer types. Consolidated Edison Company of New York, Inc. (ConEd), Jersey Central Power and Light (Jersey Central), Public Service Electric & Gas Company (PSE&G), and Connecticut Light and Power (CL&P), all investor-owned utilities, are comparable to LIPA because they operate near Long Island in power pools that LIPA is currently or will soon be connected to via underwater or underground cable.

ConEd, which serves nearly all of New York City and parts of Westchester County, is part of the NYISO marketplace. Jersey Central and PSE&G are connected to the PJM marketplace, which has access to cheaper nuclear and coal-fired generating facilities. Jersey Central serves 3,200 square miles of northern and central New Jersey out of its headquarters in Morristown, New Jersey.⁷³ PSE&G serves a 2,600 square mile diagonal corridor across the state from Bergen to Gloucester Counties.⁷⁴ CL&P serves 149 cities and towns throughout the State of Connecticut out of its headquarters in Hartford and draws power from the New England Independent System Operator (NEISO).⁷⁵

The Cross Sound Cable, a high voltage, direct current (HVDC) buried submarine cable system, connects the electric transmission grids of

⁷³ Jersey Central website. <<http://www.firstenergycorp.com>>.

⁷⁴ PSE&G website. <<http://www.pseg.com>>.

⁷⁵ CL&P website. <<http://www.cl-p.com>>.

ARE THERE COMPARABLE UTILITIES THAT
PROVIDE LESSONS FOR LIPA IN MANAGING
COSTS?

New England and Long Island.⁷⁶ The Neptune Regional Transmission System (NeptuneRTS) is a 67-mile cable project that will link Long Island to the Pennsylvania Jersey Maryland (PJM) electric grid by June 2007.⁷⁷ Each of these cables currently or will soon allow LIPA to purchase power from the NYISO, NEISO and PJM power pools. Electricity supply costs at LIPA and comparison utilities are determined, in part, by the price of electricity in each power pool.

From 1999 to 2004, comparable electric utilities, save ConEd, charged their customers less than LIPA for each kWh of electricity. Not only do most comparable electric utilities charge less, but Jersey Central and the City of Los Angeles have seen prices decrease over the same time period that LIPA has seen average price increases. LIPA's average price increased 22.5 percent from 1999 to 2004, while average prices rose 5.4 percent at PSE&G and 3.2 percent at CL&P.⁷⁸ Jersey Central and the City of Los Angeles reduced their average electric prices 0.7 percent and 7.3 percent, respectively.

Each electric utility has a different cost and organizational and regulatory structure. However, those utilities face some of the same fuel and purchased power cost pressures that LIPA has identified as the force behind each excess fuel cost surcharge increase. How each has handled financial constraints over time and taken advantage of opportunities to increase efficiencies raise questions worthy of examination by industry experts at the Department of Public Service as it considers any potential LIPA rate increase.

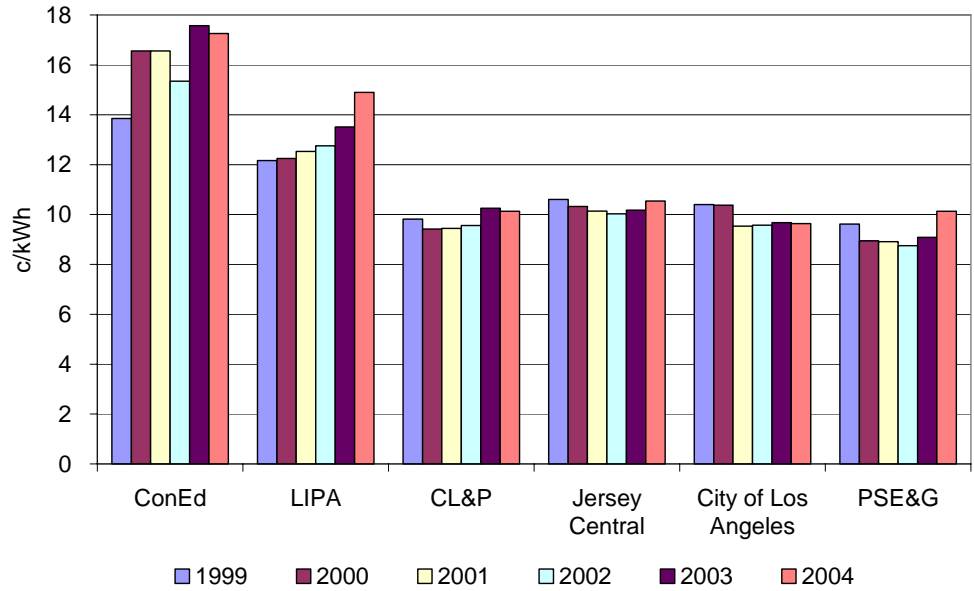
⁷⁶ Testimony in front of the House Committee on Energy and Commerce, September 4, 2003.

⁷⁷ LIPA Press Release. "LIPA Board Approves Transmission Agreement for Neptune Cable Project." September 29, 2004.

⁷⁸ Energy Information Administration, U.S. Department of Energy.
<<http://www.eia.doe.gov/cneaf/electricity/page/data.html>>.

ARE THERE COMPARABLE UTILITIES THAT PROVIDE LESSONS FOR LIPA IN MANAGING COSTS?

Average Price Comparisons - 1999 to 2004



Source: U.S. Department of Energy, Energy Information Administration

Supply Costs

From 2000 to 2003, LIPA’s supply costs per kWh increased 11.6 percent. Supply costs per kWh also increased at ConEd, Jersey Central and PSE&G during that time, but decreased at both the City of Los Angeles and CL&P. LIPA states that it has mitigated price increases by absorbing excess fuel and purchased power costs that LILCO and other electric utilities would have passed on to its customers. Based on the comparison above, ConEd, Jersey Central and PSE&G did a better job mitigating price increases, while oil, natural gas and purchased power costs rose. In contrast, the City of Los Angeles and CL&P did not face increasing per kWh supply costs.

In addition to passing along higher costs, LIPA made a series of decisions that affected fuel and purchased power costs. LIPA made the decision not to repower its existing facilities when it took over LILCO and later rented diesel-fueled mobile generators to meet short-term energy needs in periods of peak demand. The cost structure that LIPA inherited from LILCO explains part of the financial pressure it is facing from increasing fuel and purchased power costs. However, LIPA is responsible for electric supply decisions made over the past six years.

Delivery Costs

LIPA's delivery costs per kWh increased 15.2 percent from 2000 to 2003. The driving force behind delivery cost increases was an increase in LIPA's general and administrative costs of 26.3 percent. As stated above, general and administrative costs per kWh were .99 c/kWh in 2000 at LIPA and increased to 1.18 c/kWh in 2003, an increase of 19.2 percent. CP&L saw a decrease of 48.9 percent from 2000 to 2003 in its general and administrative costs per kWh, ConEd experienced a 1.4 percent decrease over the same time, and the City of Los Angeles' costs per kWh increased by 10 percent.⁷⁹ LIPA's general and administrative cost per kWh in 2003 of 1.18 c/kWh did not compare favorably with general and administrative cost per kWh at ConEd of 0.48 c/kWh, the City of Los Angeles at 0.38 c/kWh, and CP&L at 0.31 c/kWh in the same year.

Delivery costs per kWh decreased 22 percent and 1.4 percent at PSE&G and ConEd respectively, while costs per kWh increased at the City of Los Angeles, CP&L and Jersey Central. However, LIPA's 15.2 percent increase in delivery costs per kWh from 2000 to 2003 was the largest increase among comparison utilities.

LIPA's Debt and Variable Rate Exposure of Comparable Utilities

The Long Island Power Authority is the most heavily indebted municipal electric utility in the country. LIPA's exposure to variable rate debt as a percentage of total debt, before consideration of interest rate swaps, is among the highest of other publicly-owned electric utilities. After considering the effects of interest rate swap agreements, LIPA's exposure to variable interest rate is reduced to the upper half of its peers as a percentage of total debt. However, as previously noted, LIPA is heavily indebted, which allows it to carry more debt as a percent of total debt in variable rate form. The following chart compares the gross and net variable interest rate debt exposure of LIPA to several other municipal utilities. Also, in a May 2005 analysis, Moody's Investors Service reported LIPA's Debt Ratio was 211 percent when compared to other electric utilities in New York State, whose debt ratios approximated 100 percent or less.⁸⁰

⁷⁹ General and administrative expenses were not available from Jersey Central and PSE&G.

⁸⁰ Debt ratio is defined as net funded debt divided by the sum of net fixed assets plus working capital.

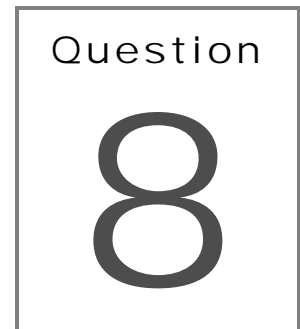
ARE THERE COMPARABLE UTILITIES THAT PROVIDE LESSONS FOR LIPA IN MANAGING COSTS?

Variable Rate Debt of LIPA and Comparable Utilities

Utility	Gross Variable	Net Variable
Long Island Power Authority	30%	21%
Jacksonville Electric Authority	24%	20%
South Carolina Public Service Authority	6%	6%
LA Dept. of Water and Power	29%	29%
Salt River Project	14%	14%
San Antonio Public Service Board	25%	25%
Memphis Light, Gas and Water	7%	7%

Source: Various audited financial statements

Note: Table presents most recent data available.



Has LIPA's Board been adequately involved in decision making as related to ratepayer costs?

The 1986 enabling legislation created an oversight Board of nine Trustees, with five appointed by the Governor, one of whom would be the chairman; two appointed by the Senate Majority Leader; and two appointed by the Speaker of the Assembly. The legislation also called for the expansion of the Board to 22 locally elected members, beginning in 1991. The original Board structure was extended twice until 1995 when the Legislature reconstituted the board to include 15 members, with nine appointed by the Governor, one of whom is the chairman; three appointed by the Senate Majority Leader; and three appointed by the Speaker of the Assembly. This legislation also eliminated the provisions dealing with the future election of certain trustees. Supporters of the legislation intended it to make LIPA more efficient and responsive to its customers, reduce the expenses associated with an election process, and streamline the decision-making process, while providing that the members of the Board were responsive to the elected officials who appointed them.⁸¹

LIPA's enabling legislation allows it to set its own rates and charges within certain parameters; the primary check on management's recommendation to adjust surcharge levels is a review by the Board of Trustees. However, Board oversight of surcharge increases has been limited, and there has been even less discussion of alternatives. In a January 2000 press release LIPA stated that increasing fuel costs were threatening its financial situation.⁸² A September 21, 2000 speech by

⁸¹ Chapter 506 of the Laws of 1995.

⁸² LIPA Press Release. "LIPA Will Hold Electric Rates Steady Despite Increased Fuel Costs." January 27, 2000.

HAS LIPA'S BOARD BEEN ADEQUATELY
INVOLVED IN DECISION MAKING AS
RELATED TO RATEPAYER COSTS?

Chairman Kessel to the Huntington Chamber of Commerce reiterated that fuel costs were increasing and stated that those increases were “putting tremendous financial pressure on LIPA” and will probably “strain LIPA's finances to the limit.”⁸³ Notably, the first time that increasing fuel costs were mentioned at a Board meeting was on September 28, 2000. At that meeting Chairman Kessel indicated he would make some recommendations to the Board in the first quarter of 2001, after LIPA's Associate General Counsel had reviewed options to “protect its ratepayers and the financial stability of LIPA” in light of fuel costs that were exceeding budgeted amounts.⁸⁴

Preparation of a plan for fuel cost mitigation was mentioned at the October 2000 Board meeting, but no details of the plan were discussed.⁸⁵ At the November 2000 Board meeting Chairman Kessel said that “the possibility of some kind of fuel cost pass-through may exist next year depending upon LIPA's final results for 2000.” At that meeting one trustee voiced his support for “a fuel cost pass-through,” but no other details of a fuel cost mitigation plan were discussed. However, it appears that not all of the LIPA Trustees were fully aware of the impact of increasing fuel costs. At the same meeting, the Board's Deputy Chairman requested that LIPA examine the possibility of “a cost squeeze from rising fuel prices, other costs and increased competition, at a time when LIPA has increased outstanding debt and carrying costs.”⁸⁶ Chairman Kessel did not agree to an examination and stated that LIPA had a “solid” budget in place for 2001. At the December 2000 Board meeting Chairman Kessel again referred to “a list of several options to be discussed with Trustees” to address concerns over the impact of rising fuel costs on LIPA's financial situation, but no further discussion was held on fuel cost mitigation at this meeting.⁸⁷

According to meeting minutes, there was no mention of a “fuel cost pass-through” at the January 23, 2001 Board meeting, the only Board meeting between December and March. However, the following resolution was adopted without comment or discussion:

⁸³ LIPA Press Release. “Kessel Says Fuel Cost Increases Straining LIPA Budget.” September 21, 2000.

⁸⁴ LIPA Board of Trustee Meeting Minutes, September 28, 2000.

⁸⁵ LIPA Board of Trustee Meeting Minutes, October 31, 2000.

⁸⁶ LIPA Board of Trustee Meeting Minutes, November 16, 2000.

⁸⁷ LIPA Board of Trustee Meeting Minutes, December 12, 2000.

HAS LIPA'S BOARD BEEN ADEQUATELY INVOLVED IN DECISION MAKING AS RELATED TO RATEPAYER COSTS?

Whereas, LIPA's unrecovered fuel and purchased power costs for the year 2000 are approximately \$296 million; now, therefore, it be resolved that the LIPA Board of Trustees hereby requests that the Citizens Advisory Panel Board formally convey to the Authority the CAP Board's position on what action the Authority should take to deal with LIPA's unrecovered fuel and purchase power costs for the year 2000, including to what extent, how and when such costs should be passed along to LIPA's customers.⁸⁸

The Citizen's Advisory Panel passed a resolution in response to the Board's request urging LIPA not to raise "electric rates" unless a full evidentiary hearing before the PSC could show that an increase was necessary and in the public interest. The resolution also urged LIPA to actively solicit public input on the matter and to provide ample opportunity for full and meaningful public participation.⁸⁹

The first time a fuel cost mitigation plan was mentioned to the public or the Board was in a February 16, 2001 press release. On February 29, 2001, in anticipation of a March 2001 meeting of the Board, then New York State Comptroller Carl McCall sent a letter to the LIPA Board of Trustees requesting that they "defer action on the proposed fuel cost mitigation plan" because information on the proposal had been "made public less than two weeks" prior. He also stated that "members of the Board could benefit from more information before making a decision."⁹⁰

When LIPA Trustees met on March 1, 2001, the "approval of the Fuel and Purchased Power Cost Adjustment with respect to year 2000 unrecovered fuel costs" was part of the agenda.⁹¹ When the item came up, Chairman Kessel opened the floor for comments from Trustees on "approval" after he presented the need for a surcharge and LIPA's efforts to limit the surcharge recovery of all fuel costs. A review of Board minutes showed there had been no record in any Board meeting minutes of "a list of several options to be discussed with Trustees" as Chairman Kessel had stated in December of 2000. In fact, the March 1,

⁸⁸ LIPA Board of Trustee Meeting Minutes, January 23, 2001.

⁸⁹ Citizens Advisory Panel. Resolution 2001-1.

⁹⁰ New York State Comptroller Carl McCall. Letter to the Members of the LIPA Board of Trustees, February 28, 2001.

⁹¹ LIPA Board of Trustee Meeting Minutes, March 1, 2001.

HAS LIPA'S BOARD BEEN ADEQUATELY
INVOLVED IN DECISION MAKING AS
RELATED TO RATEPAYER COSTS?

2001 meeting minutes show the Board's Deputy Chairman asked for an explanation as to how LIPA arrived at the \$125 million figure for proposed fuel cost recovery. Chairman Kessel responded that LIPA had worked with its financial advisor to develop a surcharge that would not have a negative impact on its debt retirement program, would mitigate the bill impact on customers and give LIPA some flexibility in dealing with higher fuel costs in the coming year.⁹²

LIPA Trustees voted unanimously to indirectly increase the cost to ratepayers by implementing its first excess fuel cost surcharge at the March 1, 2001 meeting, less than half way through its five-year agreement to not increase rates. According to LIPA, the 5.8 percent surcharge was to minimize the impact of approximately \$296 million in excess oil, gas and purchased power costs during 2000. LIPA officials stated that a pass-through of the entire cost would have amounted to a 13 percent surcharge on electric bills by LILCO, but to offset the large increase, LIPA changed the pace of its accelerated debt repayment schedule and reduced the fuel surcharge pass along to only 5.8 percent. In total, the additional fee cost ratepayers \$125 million in 2001.⁹³

More information about increasing fuel costs and their impact on LIPA was discussed with LIPA Trustees at the May 1, 2001 Board meeting, after the first surcharge increase had been approved. In fact, one Trustee requested that "in the future more information be included in the finance report on fuel costs, including gross cost, how the fuel cost was booked, how much was unable to be booked, and how much was volume driven and price driven."⁹⁴ LIPA's Budget Director agreed to include the information in the next finance report.

When the finance report was presented at the next Board meeting, actual vs. budgeted fuel costs were addressed and Chairman Kessel requested that the Finance and Audit Committee meet before the next full Board meeting to be apprised of fuel costs to date and their impact on LIPA.⁹⁵ LIPA's website does not list the meeting dates or minutes of the Finance and Audit Committee. Furthermore, fewer than half of

⁹² LIPA Board of Trustee Meeting Minutes, March 1, 2001.

⁹³ Citizens Advisory Panel. News Release. February 26, 2001.

⁹⁴ LIPA Board of Trustee Meeting Minutes, May 1, 2001.

⁹⁵ LIPA Board of Trustee Meeting Minutes, June 28, 2001.

HAS LIPA'S BOARD BEEN ADEQUATELY
INVOLVED IN DECISION MAKING AS
RELATED TO RATEPAYER COSTS?

LIPA's Trustees sit on the Finance & Audit Committee, precluding the involvement of all LIPA Trustees in certain decision-making processes.⁹⁶ At the December 28, 2001 Board meeting, Chairman Kessel stated that "a special committee, chaired by the Board's finance chairman, would be formed in 2002 to investigate LIPA's Fuel and Purchased Power Cost Adjustment policy, including whether the policy needed to be changed to better reflect fuel costs on a more regular basis."⁹⁷

In early 2003, LIPA's website contained a "Proposal Concerning Recovery of Year 2002 and Future Fuel and Purchased Power Costs." These discussions and public information should have set a precedent for more involvement by Trustees during future discussions associated with extending the current surcharge and particularly the approval of an automatic surcharge adjustment policy in February 2003. However, after that meeting, a review of Board minutes shows that Trustees held limited discussion of the following six surcharge increases.

In February 2004, following a series of public authority scandals, the Governor established the Public Authority Governance Advisory Committee (also known as the Millstein Committee). The purpose of the Millstein Committee was to improve the oversight, accountability and transparency of New York State public authorities. In its June 2004 report, the Millstein Committee highlighted certain governing principles to assist Boards of Trustees with protecting the interests of customers and State taxpayers. The report stated that "the role of a board is not primarily to fix problems once identified, but, more importantly, to avoid problems by...assuring itself that management has in place appropriate systems and processes to identify and deal with risks that management faces, to measure performance, and to assure financial transparency and internal controls; and organizing the business of the board so as to assure itself that it will be current with the conduct of the affairs of the corporation and the activities of management."⁹⁸ Limited full Board involvement in past surcharge decisions is not in line with the Millstein Committee's suggestions for enhanced governance and should be reformed to provide better oversight of management's decisions.

The New York State Commission on Public Authority Reform, established in 2005, and also chaired by corporate governance expert

⁹⁶ 2004 Long Island Power Authority Annual Public Authority Data Request.

⁹⁷ LIPA Board of Trustee Meeting Minutes, December 28, 2001.

⁹⁸ Public Authorities Governance Advisory Committee. Draft Interim Report. June 22, 2004.

HAS LIPA'S BOARD BEEN ADEQUATELY
INVOLVED IN DECISION MAKING AS
RELATED TO RATEPAYER COSTS?

Ira M. Millstein, is offering training for Board members. LIPA's Board of Trustees should take advantage of this training and improve its oversight of operational issues and decisions affecting price.

Additional Considerations

LIPA's rate setting procedure should be more transparent. By not reporting the increases in annualized terms, ratepayers are not being told the actual impact of these repeated increases. In publicized press releases, LIPA quantifies surcharge increases as significantly less than the annualized increase. For example, in September 2004, LIPA announced a 1 percent increase in the surcharge as of October 1, 2004. LIPA said this additional 1 percent would add less than \$1 per month to the average residential electric bill that totaled \$98 before the fuel surcharge. However, when annualized, this increase was actually 4.3 percent and added \$4.21 cents to the monthly bill, more than \$50 annually. Similarly, the 1.9 percent surcharge increase in June 2005 actually equaled 2.8 percent when annualized and added \$36 to ratepayers' annual bills.

LIPA has avoided PSC scrutiny of its actions that increased prices by terming them surcharges, while expanding the list of items included in a fuel and purchased power surcharge. Those actions, along with the limited oversight provided by its Board of Trustees, past misuses of ratepayer funds, and the burden higher electric prices are placing on the Long Island economy demand that the PSC conduct a thorough review of LIPA.

Regulatory review by the PSC of rate setting is intended to ensure that increased costs passed along to consumers are both just and reasonable.⁹⁹ As far back as 2001, the Citizens Advisory Panel, the watchdog group assigned to oversee LIPA's operations by the courts, was calling for PSC review.¹⁰⁰

Non-profit, municipal electric utilities in New York State who are part of the New York Municipal Power Agency (NYMPA) were placed under PSC jurisdiction on May 1, 1998 when they began purchasing power from sources other than the New York Power Authority.¹⁰¹ When NYMPA utilities request a rate increase, the PSC reviews their request

⁹⁹ Section 66 of the Public Service Law.

¹⁰⁰ Citizens Advisory Panel. Resolution 2001-1.

¹⁰¹ New York State Public Service Commission, "Case 05-E-0567: Background. Minor Rate Filing by the Village of Arcade to Increase its Annual Electric Revenues by \$299,968, or 5.3 percent," September 6, 2005.

under a cost-based approach.¹⁰² The cost-based approach estimates reasonable costs for operation plus net income equal to the utility's current incremental borrowing rate. When NYMPA utilities have applied for rate increases in the past, the full rate increase request has not always been approved by the PSC. For example, when the Village of Arcade Municipal Utilities Commission applied for a rate increase of 6.9 percent in 2005, the PSC approved an average increase of 5.5 percent.¹⁰³

As a non-profit, municipal electric utility operating in New York State purchasing power from the New York Power Authority and other sources, LIPA always should have been subject to equal regulatory treatment.

Comparing LIPA's expenses with expenses at other electric utilities shows that the benefits of creating a public utility that can bypass regulatory scrutiny in setting rates may have expired. LIPA was originally created to take over the decommissioning of Shoreham from LILCO and to implement programs that promote energy efficiency on Long Island. LIPA successfully decommissioned Shoreham in 1994 and introduced a Clean Energy Initiative (CEI), which is still in force today. Although LIPA is still paying off some residual Shoreham debt and facilitating the CEI until at least 2008 when funding is scheduled to expire, the question arises whether another entity could carry out these responsibilities more effectively, at lower cost to ratepayers.

Even before Shoreham was dismantled, officials were asking this question. In June 1992, the Executive Director of New York Citizens for a Sound Economy, a non-partisan group whose goal is to cut waste in government, said his group was in favor of eliminating LIPA, noting that, "it's just another agency created by government that was meant to expire (when its mission was accomplished). It's happened so many times. They're immortal."¹⁰⁴

¹⁰² As of December 2005, 35 New York State municipal utilities are members of NYMPA.

¹⁰³ Robinson, David. "Electricity Rates to Rise by 5.5%." *The Buffalo News*. September 24, 2005: D2.

¹⁰⁴ "Trendicator: Do We Need Both NYPA and LIPA?" *Long Island Business News*. June 15, 1992.

Finally, timely initiation of a rate proceeding is essential. LIPA has been reviewing options for changing its organizational structure and has promised a public discussion of those options.

LIPA officials deserve credit for initiating a process to identify alternatives to its current organizational structure, including privatization. A public rate setting procedure could provide insights to help inform the public discussion of options. Long Islanders weighing the future of LIPA must have the advantage of a thorough, public review of the factors affecting the prices they pay for electricity—now 96 percent higher than the national average.

Appendix A

Approved and Proposed Budgeted Fuel and Purchased Power Costs - 1999 to 2006 (thousands of dollars)

Original Charges	Approved 1999	Approved 2000	Approved 2001	Approved 2002	Approved 2003	Approved 2004	Approved 2005	Proposed 2006	Percent of 2006 Total
Total Fuel and Purchased Power (excl.9-Mile)	\$471,051	\$634,514	\$842,364	\$747,177	\$835,593	\$911,389	\$1,189,727	\$1,808,957	86.73%
9-Mile Nuclear Fuel (inc. Disp. & Decom.)	\$9,252	\$7,892	\$8,624	\$7,645	\$9,112	\$8,452	\$9,326	\$8,399	0.40%
Wheeling Charges	\$7,426	\$7,687	\$78,455	\$140,432	\$196,037	\$206,823	\$229,616	\$255,120	12.23%
Y-49 and Y-50 Cable Operating Costs	\$26,724	\$25,628	\$19,586	\$21,548	\$21,597	\$24,140	\$25,308	\$27,651	1.33%
Deferred Fuel Cost	\$68,117	-\$2,500	-\$18,483	-\$1,253	-\$46,054	\$36,900	\$36,500	\$36,500	1.75%
Petroleum Business Tax	\$46,375	\$0	\$0	\$0	\$0	\$0	\$0	\$0	0.00%
Total of Original Charges	\$628,945	\$673,221	\$930,546	\$915,549	\$1,016,285	\$1,187,704	\$1,490,477	\$2,136,627	102.44%
Additional Charges									
Energy Management Agreement	\$0	\$7,625	\$7,957	\$8,255	\$11,079	\$7,766	\$8,040	\$8,302	0.40%
Fuel Hedging Program Costs	\$0	\$0	\$0	\$14,000	\$21,968	\$17,296	\$5,624	\$13,725	0.66%
Nine Mile Wheeling Charges	\$0	\$0	\$7,328	\$7,258	\$7,328	\$7,545	\$7,823	\$8,189	0.39%
Fuel Hedge Program Financial Settlements	\$0	\$0	\$0	-\$6,065	-\$19,553	-\$3,074	-\$61,682	-\$249,934	-11.98%
Emissions Allowances Purchases	\$0	\$0	\$0	\$0	\$3,598	\$4,562	\$660	\$124	0.01%
ESCO Bill Credit Adj Payments	\$0	\$0	\$5,663	\$33,449	\$7,835	\$4,438	\$29,361	\$111,605	5.35%
Ancillary Service Revenues - Net	\$0	\$0	-\$12,000	-\$13,500	-\$5,930	-\$2,682	-\$2,645	-\$1,965	-0.09%
ISO-Related Service Costs	\$0	\$0	\$0	\$45,900	\$48,470	\$47,150	\$45,100	\$43,980	2.11%
NYPA Trans Adj Charge	\$0	\$0	\$0	\$0	\$10,913	\$8,600	\$8,777	\$8,446	0.40%
Cost of Off-System Sales	\$0	\$0	\$0	\$4,440	\$5,180	\$6,315	\$5,200	\$2,261	0.11%
Barge Lease and Transportation Costs	\$0	\$0	\$0	\$535	\$100	\$200	\$200	\$0	0.00%
Clean Energy Peak Load Reduction Rebate	\$0	\$0	\$2,207	\$3,200	\$1,610	\$1,610	\$500	\$500	0.02%
Payments Under RPS Program	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$3,888	0.19%
Power Plant Interruption Insurance	\$0	\$0	\$0	\$4,248	\$0	\$0	\$0	\$0	0.00%
Max Temp Event Option Insurance	\$0	\$0	\$0	\$2,400	\$0	\$0	\$0	\$0	0.00%
Other-One-Time Adjustments	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	0.00%
Total of Additional Charges	\$0	\$7,625	\$11,155	\$104,120	\$92,598	\$99,726	\$46,958	-\$50,879	
TOTAL - ALL CHARGES	\$628,945	\$680,846	\$941,701	\$1,019,669	\$1,108,883	\$1,287,430	\$1,537,435	\$2,085,748	

Source: LIPA's 1999 to 2006 Budgets

Appendix B

Budgeted Revenues and Expenses (thousands of dollars)

	1999 (Proposed)	2000 (Approved)	2001 (Restated)	2002 (Approved)	2003 (Projected)	2004 (Projected)	2005 (Projected)	2006 (Proposed)	% Change 1999 - 2006
Revenues	\$2,111,216	\$2,124,940	\$2,404,827	\$2,424,242	\$2,582,232	\$2,845,903	\$3,276,725	\$3,735,331	76.93%
<i>Expenses</i>									
Fuel and Purchases Power Costs	\$628,945	\$680,846	\$941,701	\$1,019,669	\$1,107,630	\$1,376,718	\$1,760,005	\$2,085,748	231.63%
Operations & Maintenance Expense	\$684,478	\$656,996	\$652,738	\$653,396	\$702,064	\$694,922	\$717,707	\$761,293	11.22%
General and Administrative Expenses	\$12,892	\$14,644	\$31,761	\$39,561	\$43,877	\$41,057	\$45,084	\$47,232	266.37%
Legal	\$1,990	\$3,495	\$3,635	\$4,401	\$4,332	\$3,861	\$6,050	\$6,324	217.79%
Financial Advisor/Cash Management	\$800	\$1,170	\$1,325	\$2,650	\$1,650	\$2,950	\$4,950	\$3,075	284.38%
Engineering	\$5,400	\$4,986	\$7,944	\$13,734	\$6,140	\$8,114	\$8,383	\$11,249	108.31%
Accounting and Audit Services	\$1,615	\$1,275	\$1,600	\$1,825	\$2,900	\$1,600	\$1,765	\$1,847	14.37%
Depreciation & Amortization	\$212,000	\$213,540	\$211,740	\$216,500	\$230,738	\$228,731	\$236,528	\$246,495	16.27%
Revenue Taxes	\$109,439	\$81,440	\$83,502	\$72,367	\$62,061	\$58,257	\$54,339	\$58,885	-46.19%
Payments in Lieu of Taxes (PILOTS)	\$151,797	\$153,524	\$144,335	\$143,447	\$151,622	\$155,444	\$169,081	\$177,043	16.63%
Total Operating Expenses	\$1,786,659	\$1,800,990	\$2,065,777	\$2,144,940	\$2,297,992	\$2,555,129	\$2,982,744	\$3,376,696	88.99%
Operating Income	\$324,557	\$323,950	\$339,050	\$279,302	\$284,240	\$290,774	\$293,981	\$358,635	10.50%
Other Income and Deductions	N/A	\$18,960	\$63,721	\$45,211	\$54,197	\$47,316	\$57,909	\$60,891	
Interest Expense and Income	\$324,092	\$341,397	\$365,135	\$324,017	\$318,437	\$318,090	\$331,890	\$344,526	6.30%
Net Income	\$465	\$1,513	\$37,636	\$496	\$20,000	\$20,000	\$20,000	\$75,000	16029.03%

Source: LIPA's 1999 to 2006 Budgets

Appendix C

2004 Data on Comparable Utilities

	ConEd	LIPA	CL&P	Jersey Central	LA	PSE&G
Customers	3,050,226	1,090,538	1,165,140	1,007,789	1,366,067	2,049,153
kWh Sold	29,868,303,000	19,105,719,000	23,404,183,000	16,308,325,000	23,482,342,000	33,954,980,000
kWh/customer	9,792	17,520	20,087	16,182	17,190	16,570

Source: Energy Information Administration - Form EIA-861: "Annual Electric Power Industry Report"

Major contributors to this report included:

Kim Fine	Deputy Comptroller
Thomas Marks	Assistant Comptroller, Chief Economist
Kristee Iacobucci	Policy Research Analyst
Darren Kempner	Policy Research Analyst
Jody Dixon	Policy Research Analyst
William O'Reilly	Debt Management Specialist
Robert Watson	Debt Management Specialist
Kathleen Kerwin	Research Assistant

Special Thanks to:

Moussa Silue	Senior Administrative Analyst, Bureau of Management Services
--------------	-----------------------------------------------------------------
