



September 16, 2013

Hon. Audrey Zibelman, Chair
New York State Department of Public Service
3 Empire State Plaza
Albany, NY 12223-1350

Dear Chair Zibelman:

On behalf of the Long Island Power Authority (“LIPA”), attached please find LIPA’s submission of the form of Amended and Restated Operations Services Agreement (“Amended OSA”) between LIPA and PSEG LI, for your review and recommendation to the LIPA Board of Trustees pursuant to the LIPA Reform Act.

Attached please also find LIPA’s supporting documentation to this submission, which includes an overview of the principal terms and conditions contained in the Amended OSA, and a comparative chart which sets forth differences between the existing Operations Services Agreement with PSEG LI dated December 28, 2011 (“Existing OSA”) and the Amended OSA.

I note that given timing constraints, this submission is in final draft form, and thus, subject to further, non-substantive revisions. In addition, this submission is incomplete, in that two of the appendices to the Amended OSA (Nos. 7 and 14) are in the process of being finalized, and will be submitted shortly.

I also note that this submission is being made on a confidential basis at this time, subject to further justification as to the confidential, trade secret nature of discrete provisions of the agreement and/or its appendices.

Thank you for your continued cooperation in this matter and please do not hesitate to contact me if you have any questions or require anything else in connection with this submission.

Sincerely,

Lynda Nicolino
General Counsel and Secretary

cc: John D. McMahon, LIPA COO
Kimberly Harriman, DPS ALJ

LONG ISLAND POWER AUTHORITY
Submission to the NYS Department of Public Service
Related to the Operations and Services Agreement with PSEG LI

In December 2011, pursuant to a Request for Proposals for a new services agreement released by the Long Island Power Authority (the “Authority”) in June 2010, the Authority’s operating subsidiary, LIPA (“LIPA”), entered into an Operations Services Agreement (the “Existing OSA”) with PSEG Long Island LLC, a New York limited liability company (the “Service Provider”) to provide the day-to-day management and operation of LIPA’s electrical transmission and distribution system (“T&D System”) in the counties of Nassau, Suffolk and the Rockaways portion of Queens. The Existing OSA provides for the Service Provider to begin operation of the T&D System on January 1, 2014.

Primarily related to implementing the LIPA Reform Act recently enacted by the New York State legislature at the initiative of Governor Andrew M. Cuomo, the Authority is now proposing that LIPA enter into an Amended and Restated OSA (“Amended OSA”) (the form of which is attached hereto as Exhibit A) with the Service Provider to address the different relationship between the parties in connection with the provision of electric service in LIPA’s service territory. As indicated in the legislative history of the LIPA Reform Act¹, the LIPA Reform Act was enacted in response to a number of criticisms of the Authority and the current service provider, including, among others, (a) the difficulties encountered by the Authority and the service provider in the context of Hurricanes Irene and Sandy related to storm preparation, response and restoration of customer service; (b) the overlapping responsibilities between the Authority and the service provider with respect to service, operations and management, which led to customer confusion, limited accountability and disconnected management, planning and operational processes, and (c) the lack of oversight and transparency in the Authority’s ratemaking process.

LIPA Reform Act

The LIPA Reform Act amends the New York Public Service Law (“PSL”) and the New York Public Authorities Law (“PAL”) imposing additional regulatory oversight and requirements on the Authority and mandating additional duties for any service provider operating the T&D Systems.

The LIPA Reform Act establishes a separate office in The New York State Department of Public Service (“DPS”), to review and make recommendations with respect to the operations and terms and conditions of service of, and rates and budgets established by the Authority and/or its service provider; review capital expenditures proposed by the service provider; review the emergency response plan of the Authority and the service provider; undertake a comprehensive and regular management and operations audit of the Authority and service provider; accept, investigate, mediate to resolve and make recommendations to the Authority and/or the service

¹ The act and related legislative history is available at <http://assembly.state.ny.us/leg/?bn=A08073&term=2013>.

provider regarding the resolution of complaints from consumers in the Authority's service territory relating to, among other things, the provision of electric service provided by the service provider and/or the Authority; review the net metering program; review and make recommendations with respect to any proposed plan submitted by the Authority and/or the service provider related to implementation of energy efficiency measures, distributed generation or advanced grid technology programs; and review the data, information and reports and other pertinent information related to the metrics in the operations services agreement, the Authority's evaluation of such data, information and reports, and make recommendations to the Authority with respect to the service provider's annual incentive-based compensation.

The LIPA Reform Act amends PAL to substantially change the way the Authority and LIPA operate the T&D System. The LIPA Reform Act imposes new substantive obligations on a service provider and effectively shifts the major operational and policy-making responsibilities for the T&D System, including significant responsibilities relating to capital expenditures and emergency response, from LIPA to the service provider. Consistent with this approach, the LIPA Reform Act requires that staffing at the Authority be kept at levels only necessary to ensure that the Authority is able to meet obligations with respect to its bonds and notes and all applicable statutes and contracts, and oversee the activities of the service provider. The LIPA Reform Act imposes a number of new obligations on the service provider, including requiring the service provider to prepare and maintain an emergency response plan to assure the reasonably prompt restoration of service in the case of an emergency event and establish separate responsibilities of the Authority and service provider; submit for review to DPS a report detailing the service provider's planned capital expenditures; consider, consistent with maintaining system reliability, renewable generation and energy efficiency program results and options in establishing capital plans; submit to DPS for review, any and all data, information and reports which set forth the service provider's actual performance related to the metrics in the operations services agreement, including the Authority's evaluation thereof prior to the Authority's determination of the service provider's annual incentive compensation.

Proposed Amended OSA

Overview

Implementation of the LIPA Reform Act will require the transfer of substantial operational duties and obligations to the Service Provider in the Amended OSA and greater operational flexibility for the Service Provider. Accordingly, the Amended OSA permits, for example, the Service Provider to independently set a range of operational policies, and LIPA no longer has a contractual right to approve subcontractors (subject to certain limitations) and a joint operating committee no longer exists. However, the Service Provider will continue to be required to operate the T&D System in a manner consistent with prudent utility practice and other "Contract Standards." As such, the Amended OSA contains a significant number of changes in the operational provisions of the Amended OSA which are intended to conform the agreement to both the new requirements under the LIPA Reform Act and the "Term Sheet for Amendments to the Operations Services Agreement" dated June 6, 2013 ("Term Sheet", attached as Exhibit B) which was negotiated between the parties and the Governor's Office in conjunction therewith. The Term Sheet sets forth the material, substantive terms of proposed amendments to the Existing OSA in order, among other things, to reflect a realignment of the rights and

responsibilities of the Parties such that the Service Provider has, to the extent legally permissible and subject to the terms of LIPA's Bond Resolutions and bond and other financing agreement covenants, contractual and legal obligations and oversight responsibilities, autonomy and responsibility to operate and maintain the T&D System and establish related plans, policies, procedures and programs.

There are numerous changes to the Existing OSA that stem either directly or indirectly from the LIPA Reform Act and/or the Term Sheet, and were made to best reflect the understanding and needs of the Parties in consideration of the new operating structure, a key element of which is identifying PSEG LI as the utility brand in LIPA's service territory. A comparison of the key terms and conditions between the Existing OSA and the Amended OSA, along with the source of the change, is attached hereto to assist in your review of the Amended OSA (see Exhibit C).

Key Provisions:

Term

The primary change in the term of the Amended OSA is an extension of the Existing OSA term from 10 to 12 years. Additionally, the Amended OSA includes a provision that in the event that the Service Provider achieves certain levels of performance with respect to criteria set forth in Appendix 9 of the Amended OSA during the initial term, the parties will negotiate in good faith an 8 year extension of the term of the Amended OSA on substantially similar terms and conditions.

Compensation

The Amended OSA, with certain modifications, retains the compensation structure of the Existing OSA: (1) the annual fixed component or Fixed Direct Fee as referred to in the 2012 IRS Ruling Letter; (2) the Incentive Compensation Component; and (3) the Reimbursement of Pass-through Expenditures.

Fixed and Incentive Compensation. The Amended OSA increases the annual fixed component of the Management Services Fee after the 2015 contract year from \$36.3 million to \$58 million and increases the annual Incentive Compensation Pool after the 2015 contract year from \$5.44 million to \$8.7 million, consistent with the Service Provider assuming additional responsibilities and the obligation to use the PSEG brand related to the provision of electric service on Long Island.

The Amended OSA deletes the provisions providing for adjustments to the fixed fee based on reduced credit support but retains reductions because of poor performance. As required by the LIPA Reform Act, the Amended OSA also reflects the fact that DPS is required to review, and may make recommendations to the Authority with respect to, the Service Provider's incentive compensation.

Pass-Through Expenditures. The Amended OSA has identified and included a number of additional costs resulting from the restructuring that will be treated as pass-through expenditures. As discussed below, pass-through expenditures will now also include payments in

connection with certain power supply management, fuel procurement and related services that have historically been provided pursuant to separate agreements between LIPA and the relevant vendor outside the Existing OSA. Those agreements are incorporated into the Amended OSA, with services to commence in January 2015, and are generally consistent with the terms and conditions previously agreed to by LIPA and its current service providers. Including these agreements as appendices to the Amended OSA is consistent with the Term Sheet and the goal of having most, if not all, electric-related services centralized in one service provider group.

The Amended OSA will modify the pass-through expenditure provision regarding transactions with affiliates of the Service Provider. As under the Existing OSA, in transactions involving an affiliate, the affiliate may provide an operations service specifically set forth in the Amended OSA that is comparable to a service generally made available to other regulated transmission and distribution utilities affiliated with the Service Provider. The Amended OSA clarifies that such services will be at Service Provider's total costs (as defined in the Amended OSA) incurred in connection with such transaction (including reasonable and demonstrable costs incurred which are necessary to integrate ServCo with such affiliate), but in any event will not include a profit or mark-up component for the affiliate. The Amended OSA includes one new exception to this, which is that transactions with an affiliate under which the affiliate agrees to provide a service relating to the T&D System not specifically set forth in the preceding sentence and which have been approved by LIPA, may include profit or mark-up paid or payable to the affiliate.

Other Cost or Payment Provisions

Additional cost and payment provisions have been added to the Amended OSA that, while technically not part of the compensation arrangements, are nevertheless related to the restructuring of services, as summarized below:

Non-Storm Emergencies. The Amended OSA adds a provision that if an event or condition, other than a storm event, that is beyond the reasonable control of the Service Provider, occurs and if the Service Provider determines that certain non-budgeted expenditures are required in order for it to provide operations services in accordance with the contract standards or repair, replace or restore damaged components of the T&D Systems, the Service Provider shall make such expenditures and elect, in its sole discretion, to treat the expenditures as either (i) reallocations between different budget items, (ii) excess expenditures or (iii) "Non-Storm Emergency Expenditures." If the Service Provider elects to treat the expenditures as Non-Storm Emergency Expenditures, the Service Provider shall submit a request to LIPA to approve the Non-Storm Emergency Expenditures and approve a budget amendment to the then-current approved budget to cover such expenditures. If LIPA agrees that such expenditures are required in order for the Service Provider to provide Operations Services in accordance with Contract Standards, such expenditures shall then qualify as Non-Storm Emergency Expenditures, whereupon LIPA shall either (i) approve as promptly as practicable the proposed Budget amendment or (ii) permit the Service Provider to include in the relevant budgets for subsequent contract years a separate account sufficient to provide for the Non-Storm Emergency Expenditures over the remainder of the term.

Disallowed Costs. Consistent with the concept of increased autonomy and operational control on the part of the Service Provider, but in order to provide an incentive against excessive and/or unreasonable expenditures, the Amended OSA adds a provision that in the event that (i) all or a portion of certain costs incurred by the Service Provider in connection with a Major Storm Event or Non-Storm Emergency Expenditures are determined to have been incurred unreasonably and imprudently, applying the same scope of review and standards as those DPS applies to investor owned utilities and/or (ii) FEMA denies reimbursement of all or a portion of certain Major Storm Costs or Non-Storm Emergency Expenditures incurred by the Service Provider on grounds that actions taken by the Service Provider were in violation of FEMA standards for reimbursement and such denial becomes final, the Service Provider will be liable for such costs (and such costs shall not be treated as Pass-Through Expenditures) up to an amount of (x) \$5 million in each of contract year 2014 and 2015 and (y) \$10 million in each contract year after 2015, in each case in the aggregate for Major Storm Costs and Non-Storm Emergency Expenditures; provided, however, that the Service Provider will have no such liability for the relevant contract year in the event LIPA terminates the Amended OSA Agreement due to a Major Storm Performance Metric failure by the Service Provider, whereupon all such Major Storm Costs and Non-Storm Emergency Expenditures will be reimbursed by LIPA.

Service Provider Termination Fee. The provisions of the Amended OSA regarding payments to be made to the Service Provider upon termination of the Amended OSA are generally the same as the Existing OSA. The Amended OSA adds additional termination rights providing the Service Provider with the right to terminate the Amended OSA in the event of either a (i) LIPA privatization, (ii) LIPA municipalization or (iii) Change in Regulatory Law (as defined). The Amended OSA adds a provision that the Service Provider will be entitled to a termination fee in addition to all other amounts payable to the Service Provider upon termination under the Amended OSA payable by LIPA upon early termination of the Amended OSA (i) by LIPA or by the Service Provider due to a privatization (unless the Service Provider or an affiliate is a purchaser of the T&D System or LIPA in such transaction or enters into a replacement agreement with the successor owner to operate the T&D System or LIPA) or a municipalization (ii) by the Service Provider for an event of default by LIPA, or (iii) by the Service Provider due to a change in regulatory law (other than a FERC regulatory change). The Service Provider termination fee will be equal to \$66.7 million (in 2011 Dollars escalated by CPI), subject to a 10% annual reduction commencing in the 2021 contract year so that by the 2025 contract year, the Service Provider termination fee amount will be equal to 50% of the amount of the initial Service Provider termination fee.

Capital Improvements by Service Provider. The Amended OSA retains the provisions of the Existing OSA regarding capital improvements and generally provides that all additions to the T&D System purchased or constructed in conjunction or for the use with any part of the T&D System during the term are the property of LIPA. New provisions have been added to the Amended OSA giving the Service Provider or its designated affiliate the opportunity to propose to LIPA, capital investments which would be made and owned by the Service Provider in those programs and projects which are set forth in Appendix 8 to the Amended OSA, but only if they can be expected to result in a meaningful reduction in customer energy usage and the overall cost of energy in the Service Area. No such investments may be made if they (i) would in any manner jeopardize, in LIPA's sole discretion, the tax exempt status of the Authority's bonds or

violate the Bond Resolutions or related bond covenants; or (ii) would violate any of LIPA's related local franchise agreements. If LIPA decides to accept the Service Provider's proposal and the Service Provider should make any such capital investments, the Service Provider will have the opportunity to earn a reasonable rate of return thereon consistent with the returns permitted to be earned on such investments by New York electric transmission and distribution utilities. The Authority's acceptance of such a proposal would be subject to applicable procurement rules and guidelines governing such a solicitation and would depend upon all of the circumstances at the time.

Service Provider as LIPA's Agent. The Amended OSA designates the Service Provider as LIPA's agent to enter into purchase, rental and other contracts on behalf of and for the account of LIPA as necessary or appropriate to properly operate and maintain the T&D System and to maintain the records of LIPA, and to make such additions and extensions to the T&D System and to enter into certain customer-related contracts under LIPA's tariff, as required from time to time by LIPA. The designation as agent is intended to enhance the financial benefits and relationship between the parties under the agreement, including the ability to achieve certain sales tax saving.

DPS Review

In accordance with the LIPA Reform Act, the Amended OSA contains provisions related to the process to be invoked in connection with rate proceedings, including the statutorily mandated three-year rate plan for the 2016-2018 period and rate proposals that seek to increase rates in excess of 2.5% of aggregate revenues on an annual basis. Also as provided in the LIPA Reform Act, the Amended OSA sets forth the process and agreement between the parties related to other rate proposals submissions to DPS, irrespective of its effect on rates. These provisions are intended to clarify the intent expressed in the Term Sheet and the requirements under the LIPA Reform Act, and to ensure that each party has a full and fair opportunity to be heard and fulfill its statutory and contractual obligations and goals. The Amended OSA clearly reflects the LIPA Board's ability to set final and interim rates.

Three Year Rate Plan. The Amended OSA provides that the Service Provider will prepare a preliminary "Three Year Rate Plan" with information supplied by LIPA, designed to ensure that LIPA and the Service Provider are able to provide safe and adequate transmission and distribution service in the service territory at rates which are (i) at the lowest level consistent with sound fiscal operating practices and (ii) sufficient to generate revenues necessary to satisfy LIPA's obligations to its bondholders, lenders and other creditors and contract counterparties including the Service Provider. Each party will prepare its own budget portion, and then the Service Provider will consolidate them for presentation in the rate case. In order to ensure the confidentiality of each Party's information, the Parties will enter into a joint defense agreement (or other similar agreement) prior to the Service Provider sharing the preliminary Three Year Rate Plan with LIPA for its review, which must occur within 30 days. The Parties must work together to reach agreement on the components of such rate plan; however, if such agreement cannot be reached, the Service Provider shall submit the plan to DPS, but without invoking a dispute resolution proceeding.

DPS Rate Proceeding. The Amended OSA sets forth that in any DPS rate proceeding (i.e., related to the Three Year Rate Plan or for increases in excess of 2.5% or otherwise), LIPA will be responsible for providing evidentiary and other support and submitting its views with respect to the LIPA portion of the rate plan, and the Service Provider will be responsible for the rest of the rate plan, and may submit its own views on LIPA's portion as well. Prior to the submission of a final recommendation from DPS, if a draft recommendation is proposed to either Party, the Parties are required to work together to determine if the proposed recommendation is consistent with the Amended OSA and LIPA's statutory obligations. If the Parties are unable to agree on such a conclusion, but the recommendation is presented to the LIPA Board for approval anyway, the Service Provider may present its views about the recommendation to the Trustees at any Board meeting prior to a vote. Upon receipt of a final recommendation from DPS to LIPA, the Parties have 21 days to negotiate and finalize a budget, during which time the LIPA Board may not take final action to adopt the DPS recommendation. If agreement is not achieved within 21 days, then the Parties will proceed to expedited arbitration, the result of which will be either a mutual agreement in writing between the Parties, or a final, binding arbitration award that the LIPA Board would adopt.

Customer Rate Changes. The Amended OSA allows either Party to propose and negotiate with the other Party, a proposed rate change deemed to be necessary, upon the same basis as stated above. At the end of such negotiations, the Service Provider will prepare a proposal within 30 days for LIPA's review and within 30 days thereafter, the Parties will engage in good faith discussions to reach agreement on the rate change proposal. Following this process, LIPA can implement a change in rates or charges provided it is consistent with the Amended OSA and the LIPA Reform Act.

Voluntary DPS Rate Filing. For any rate case that is permitted, but not required under the LIPA Reform Act, the Amended OSA sets forth that the process described above will be followed for a DPS proceeding. The Parties further agree, however, that notwithstanding the fact that the LIPA Reform Act permits a voluntary filing at any time, given the limited timeline and resources available in 2014 to pursue such a filing prior to submission of the Three Year Rate Plan for 2016-2018, neither Party will submit a rate change to DPS for review before final approval of the Three Year Rate Plan unless LIPA determines a need to increase rates as a result of a Major Storm or, in order to comply with its bond covenants, the LIPA Board concludes that such a rate increase and filing is necessary for the provision of safe and adequate service. In such event, the Parties will work to reach agreement on the need, appropriateness or advisability of such a filing with DPS. The Amended OSA further provides that neither Party will voluntarily submit to DPS a rate decrease proposal for a period already covered by an approved budget unless the portion of the rate plan to be submitted to DPS that relates to the other Party's budget portion is sufficient to satisfy the revenue requirements generated by that portion of the budget.

Additional Termination Rights

As stated above, and consistent with the Term Sheet, the Amended OSA adds additional termination rights providing the Service Provider with the right to terminate the Amended OSA in the event of either a (i) privatization, (ii) municipalization or (iii) Change in Regulatory Law

(as defined), with in almost all cases, a termination fee. In the case of privatization and municipalization these rights are intended to compensate the Service Provider for the lost opportunity resulting from LIPA's or the State's determination to make LIPA fully private or public. With respect to a change in regulatory law, the Amended OSA allows the Service Provider to exit the service territory, and effectively withdraw its brand name, if the change in regulatory law materially alters the business arrangement between the Parties.

The Amended OSA provides that in the event of a Change in Regulatory Law that results in rate or other substantive regulation of the Service Provider by DPS, the Service Provider may terminate the agreement one day prior to such change in law, unless waived by the Service Provider. In the event of any other Change in Regulatory Law, the Service Provider would provide LIPA with a 12-month notice of termination (or 14 months in the case of an OSA Change (as defined) or a FERC Regulatory Change (as defined) to allow for a 2-month period to negotiate a potential resolution). Such period may be extended, at LIPA's option for an up to additional 6 months at a monthly option exercise fee of 1.175 times the monthly management fee. If the termination date is delayed beyond such extension (for example, due to an arbitration or judicial order), the Service Provider will continue to provide service for an additional monthly fee of 1.55 times the monthly management fee. The notice period, with the optional extensions, is anticipated to give LIPA sufficient time to take appropriate action in the event a termination is triggered by the Service Provider, which could include issuing another competitive procurement for a new service provider. Payment of the higher monthly fee(s) is largely within LIPA's control, and serves as an incentive to take prompt steps to effectuate a transition of service providers, or any other suitable course of action.

In the event of a FERC Regulatory Change, LIPA may institute arbitration as its sole remedy to delay the scheduled termination date as necessary in the public interest, and as fair and equitable to the Parties. If LIPA is successful, the termination date will only be delayed only to the extent found necessary by the arbitrators.

Performance Metrics

The performance metrics in the Amended OSA are consistent with those in the Existing OSA, in that they remain designed to achieve LIPA's desired performance levels, which is generally first quartile performance as determined by agreed industry peer benchmarks. The performance metrics are structured to both maintain good performance and improve poor performance, through two distinct types of performance metrics, "Maintenance metrics" and "Improvement metrics." Maintenance metrics are currently at first quartile performance levels and the objective is to maintain that satisfactory level of performance. Improvement metrics are currently lower than first quartile performance levels and the objective is to improve the level of performance to first quartile performance.

Under the Amended OSA, the Service Provider is still evaluated based on target and minimum performance metrics related to incentive compensation or penalties with respect to budget compliance, reliability, operational and customer satisfaction goals. The metrics are arranged in tiers 1-3, and can be adjusted over time to address improvement and/or maintenance performance goals. Under the Amended OSA, performance metrics are essentially the same but

are streamlined to include fewer metrics (21 vs. 27 tier 1 metrics), while still providing more focus and accountability on the JD Power results for residential and business customers. In addition, the penalty metrics are streamlined to adjust and reduce the customer survey performance goal by 10% (from 70% to 60% of the total points assigned), with no change to the SAIDI metric, which will remain at first quartile.

Attachments:

Exhibit A - Amended OSA (clean versions)

Exhibit A-1 - Amended OSA (redlined vs. Existing OSA)

Exhibit B – Term Sheet dated June 6, 2013

Exhibit C – Comparative Chart