October 15, 2014

MEMORANDUM TO THE TRUSTEES

FROM THE PRESIDENT and CHIEF EXECUTIVE OFFICER

SUBJECT: New York Power Authority Other Post-Employment Benefits and Nuclear Decommissioning Trust Funds: Selection of Fixed-Income Investment Managers

SUMMARY

The Trustees are requested to approve the award of multiyear procurement contracts to MacKay and Shields LLC ("MacKay & Shields") of New York, NY, Garcia Hamilton & Associates, L.P. ("Garcia Hamilton") of Houston, TX, and CS McKee L.P. ("CS McKee") of Pittsburg, PA for professional investment management services in connection with the Authority's Other Post-Employment Benefits Trust ("OPEB Trust") and Nuclear Decommissioning Trust ("NDT") Fund. Specifically, MacKay & Shields will replace fixed-income manager Bradford & Marzec LLC ("Bradford & Marzec") in the OPEB Trust and Garcia Hamilton and CS McKee will replace J.P. Morgan Investment Management ("J.P. Morgan") in the NDT Fund.

BACKGROUND

Section 2879 of the Public Authorities Law and the Authority's Guidelines for Procurement Contracts require the Trustees' approval for procurement contracts involving services to be rendered for a period in excess of one year. Moreover, the Authority's Expenditure Authorization Procedures require the Trustees' approval for the award of personal services contracts in excess of $1 million if low bidder, or $500,000 if sole-source or non-low bidder. The terms of the contracts considered herein are for more than one year and, in some cases estimated to exceed the dollar thresholds over the term of the agreement, therefore, the Trustees' approval is required.

OPEB Trust

Certain Governmental Accounting Standards Board ("GASB") standards[1] issued in 2004 require governmental employers to account for other post-employment benefit ("OPEB") liabilities on an "accrual" basis (i.e., as the benefits are earned during the working career of the employee) rather than on a "pay-as-you-go" basis, where costs are recorded as the benefits are paid during the employee's retirement years. OPEBs may include medical, prescription drug, dental, vision, life and other long-term care benefits for retirees and eligible beneficiaries. Similar GASB standards for pensions have existed since 1994. The Authority began reporting

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[1] These standards include Statement No. 43 – Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans and Statement No.45 – Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions.

its OPEB obligations in this manner in 2002. The GASB rules do not mandate funding of the accrued OPEB obligations, only a recognition of the accrued OPEB liability on the employer's financial statements. If left unfunded, however, the amount of the unfunded liability could significantly impact the employer's overall financial condition and its credit rating with an attendant impact on the cost of debt financing.

At their July 31, 2007 meeting, the Trustees (1) approved the creation of the Power Authority of the State of New York Other Post-Employment Benefits Trust (the "Trust"); (2) adopted the Trust Investment Policy Statement; (3) appointed a Trustee Custodian and (4) approved an initial $225 million funding plan. Subsequently, in October 2011, the Trustees approved an on-going annual funding plan for the OPEB Trust and certain amendments to the Investment Policy Statement clarifying diversification and credit quality standards.

As of August 31, 2014, the market value of assets held in the OPEB Trust Fund totaled $450 million, of which $301 million were invested in equities, $122 million were invested in fixed income securities, and $27 million were invested in real estate investment trust securities. When compared to the actuarial accrued liability of $573 million (as of December 31, 2013), this represents a funding level of 79%. The fixed-income portion of the OPEB Trust is currently managed by two portfolio managers: Bradford & Marzec, with assets under management of $62 million, and Wells Capital Management Inc., with assets under management of $57 million. The Bradford & Marzec agreement is scheduled to expire in accordance with its terms on November 2, 2014.

<u>NDT Fund</u>

Pursuant to U. S. Nuclear Regulatory Commission ("NRC") ruling NUR-0584, the Authority established the NDT Fund in 1990. The purpose of the fund is to ensure that there are sufficient funds available to pay for the decommissioning costs (i.e., removing the spent fuel and dismantling any systems or components containing activation products) of the James A. FitzPatrick ("FitzPatrick") and Indian Point 3 ("IP3") Power Plants at license expiration. On November 21, 2000, the Authority completed the sale of its IP3 and FitzPatrick nuclear plants to two subsidiaries of Entergy Corporation pursuant to a purchase-and-sale agreement dated March 28, 2000. In accordance with the Decommissioning Agreements, the Authority retains contractual decommissioning liability until license expiration, a change in the tax status of the fund or any early dismantlement of the plants, at which time the Authority will have the option to terminate its decommissioning responsibility and transfer the plant's fund to the Entergy subsidiary owning the plant. At that time, the Authority will be entitled to be paid an amount equal to the excess of the amount in the fund over the Inflation-Adjusted Cost Amount (a fixed estimated decommissioning cost amount adjusted in accordance with the effect of increases and decreases in the NRC's minimum cost-estimate amounts applicable to the plant), if any. The Authority's decommissioning liability is limited to the lesser of the Inflation-Adjusted Cost Amount or the amount of the plant's fund, guaranteeing that no additional cost burdens may be placed on the Authority.

As of August 31, 2014, the market value of assets held in the NDT Fund totaled $1.39 billion, of which $530 million were invested in equities and $856 million were invested in fixed-income securities. The fixed-income portion of the NDT Fund is currently managed by five portfolio managers: J.P. Morgan, with assets under management of $230 million, Garcia Hamilton, with assets under management of $152 million, Prudential, with assets under management of $235 million, Bradford & Marzec, with assets under management of $125 million, and Schroders, with assets under management of $114 million. The J.P. Morgan agreement is scheduled to expire in accordance with its terms on November 3, 2014.

DISCUSSION

On May 23, 2014, the Authority solicited a Request For Proposals ("RFP") for professional fixed-income investment management services by notice to a number of firms providing such services and advertisement in the *New York State Contract Reporter* in order to determine qualified fixed-income portfolio managers for the OPEB Trust and the NDT Fund. On or before June 24, 2014, the Authority received a total of 75 proposals.

Authority staff, with the support of its financial advisor, PFM Advisors ("PFM"), evaluated each proposal, taking into consideration quantitative and qualitative criteria. From a quantitative standpoint, staff evaluated historical performance; various risk metrics (including, but not limited to, each manager's standard deviation, Sharpe Ratio, tracking error and Information Ratio), and the schedule of fees. From a qualitative standpoint, firms were evaluated based on team duration and experience, investment style and research capabilities. After conducting an extensive review and analysis of each proposal, Authority staff, with the concurrence of PFM, invited the eight firms with the highest relative rankings to give oral presentations. Based on the above criteria and oral presentations, the following firms were identified to have the highest overall rankings to manage the fixed-income assets in the OPEB Trust and the NDT Fund: MacKay & Shields for the OPEB Trust, Garcia Hamilton and CS McKee for the NDT Fund.

MacKay & Shields' strategy is targeted to minimize downside risk in the portfolio by conducting rigorous credit screening analysis on all potential securities and to eliminate the ones with the highest risk. While being highly risk aware, MacKay & Shields has shown the propensity to deliver strong performances, historically, through security selection from domestic and international markets. It is recommended that MacKay & Shields manage **$62 million** in assets.

As a result of **Garcia Hamilton's** high quality investment strategy, conservative investment philosophy and success in managing the Authority's assets, it is recommended that Garcia Hamilton manage an additional **$75 million** in assets. Garcia Hamilton is 100% employee-owned, with almost 75% of the firm owned by ethnic minority and women partners. To complete the reallocation of J.P Morgan's assets under management, it is also recommended that **CS McKee** manage **$155 million** in assets due to their disciplined risk management practice, higher quality investment focus, and value driven security selection approach.

It is recommended that the three firms be awarded five-year contracts, with asset allocations as noted below, subject, however, to early termination at any time by the Authority on 60 days' notice. The allocation amounts are based on the assets' ending market value as of August 31, 2014 and will be adjusted proportionally for the actual asset value on the transition date of the assets.

	Asset Allocations (in $millions)
MacKay & Shields	62
Garcia Hamilton	75
CS McKee	155
Total	292

FISCAL INFORMATION

The fees for the three recommended investment managers are expected to range from 16 basis points to 35 basis points (a basis point is equal to 1/100th of 1%, or 0.01%) dependent on investment management style and the amount of assets under management, subject to negotiation, and will be paid from the OPEB Trust and the NDT Fund.

RECOMMENDATION

The Deputy Treasurer recommends the Trustees' approval of the award of multiyear service contracts to MacKay and Shields LLC, Garcia Hamilton & Associates, L.P., and CS McKee L.P. for professional investment management services in connection with the Authority's Other Post-Employment Benefits Trust and Nuclear Decommissioning Trust Fund.

For the reasons stated, I recommend the approval of the above-requested action by adoption of the resolution below.

Gil C. Quiniones
President and Chief Executive Officer

<u>R E S O L U T I O N</u>

RESOLVED, That pursuant to the Guidelines for Procurement Contracts adopted by the Authority, the award of the multiyear investment management service contracts to MacKay and Shields LLC, Garcia Hamilton & Associates, L.P., and CS McKee L.P., for professional investment management services in connection with the Authority's Other Post-Employment Benefits Trust and Nuclear Decommissioning Trust Fund, as recommended in the foregoing memorandum of the President and Chief Executive Officer, is hereby approved and the execution of such contracts by the Executive Vice President and Chief Financial Officer or the Treasurer, subject to the approval of the form thereof by the Executive Vice President and General Counsel, on behalf of the Authority is approved; and be it further

RESOLVED, That the Chairman, the Vice Chair, the President and Chief Executive Officer, the Chief Operating Officer, the Executive Vice President and Chief Financial Officer and all other officers of the Authority are, and each of them hereby is, authorized on behalf of the Authority to do any and all things and take any and all actions and execute and deliver any and all agreements, certificates and other documents to effectuate the foregoing resolution, subject to the approval of the form thereof by the Executive Vice President and General Counsel.