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Hon. Janet Hand Deixler
Secretary
Public Service Commission
of the State of New York
Three Empire State Plaza
Albany, New York 12223

Re: Cases 00-E-1273 and 00-G-1274 (Central Hudson Gas & Electric Corporation - Electric and Gas Rates)

Dear Secretary Deixler:

Enclosed please find an original and twenty-four (24) copies of a "Reply Brief on Behalf of Central Hudson Gas & Electric Corporation" for filing with the Commission.

Copies are being served upon the parties on the attached list.

Respectfully submitted,

Robert J. Glasser

RJG:cw
Enclosures
a00E1273jhd.wpd

cc: Service List

Service List
Cases 00-E-1273 and 00-G-1274 (Central Hudson Gas & Electric Corporation - Electric and Gas Rates)

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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Proceeding on Motion of the Commission as to rates, charges, rules and regulations of Central Hudson Gas & Electric Corporation for electric service	:	Case 00-E-1273
Proceeding on Motion of the Commission as to rates, charges, rules and regulations of Central Hudson Gas & Electric Corporation for gas service	:	Case 00-G-1274 Before the Honorable Rafael A. Epstein Administrative Law Judge

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REPLY BRIEF ON BEHALF OF
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PUBLIC SERVICE COMMISSION

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REPLY BRIEF ON BEHALF OF
CENTRAL HUDSON GAS & ELECTRIC CORPORATION

I. INTRODUCTION

In this brief, Central Hudson Gas & Electric Corporation ("Central Hudson" or the "Company") replies to positions, statements or arguments advanced in the initial briefs of other parties. To the extent not addressed herein, the Company will rely on its filings and its initial brief.

II. CUSTOMER BENEFITS

A. Overview of Total Benefits

The total benefits produced by Central Hudson in implementing its restructuring were estimated as $799 million on a pre-tax basis.[1] On a net basis, the total amount of benefits, after recognition of taxes, the costs of the transactions and extinguishment of NMP2 strandable costs is approximately $153.3 million.[2] The $153.3 million (net of tax) net amount is equivalent to approximately $333.8 million on a pre-tax basis and is equivalent to about 160% of the Company's total (electric and gas) revenue requirement.

B. <u>Central Hudson's Sharing Proposal</u>

Central Hudson proposed that its investors share in 20% of the net amount (<u>excluding</u> the NMP2 sales proceeds)[3] or, alternatively, receive the return of excess earnings deferred under the Restructuring Settlement Agreement to mitigate strandable costs, now non-existent.[4] Quantitatively, on a net of tax basis, these requests are $23.4 million or, alternatively,

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[1] The $799 million amount did not include economic benefits of about $100 million (NPV) from the fossil auction TPA and the NMP2 PPA/RSA that will be realized over three years in the case of the TPA, ten years in the case of the NMP2 PPA and from ten to twenty years from now in the case of the NMP2 RSA. Thus, a more complete estimate of the present value of the benefits produced by Central Hudson is $900 million.

[2] CHGEIB 8.

[3] Central Hudson initially quantified this formulation at $24.7 million. See, CHGEIB at 10, note 10.

[4] Mr. Mavretich's letter (at 3) states that Central Hudson "abandoned" its original request. Mr. Mavretich's assertion is unsupported and incorrect (see, CHGEIB 12, note 14).

$5.1 million,[5] and are equivalent to 15.2% or 3.3%, respectively, of the $153.3 million net of tax, net benefit pool (<u>including</u> the NMP2 sale) (CHGEIB 8).[6]

The total benefits including the present value of the TPA and PPA approach five times Central Hudson's annual delivery rate (gas and electric) revenue requirements of $202 million. Staff conceded that it was unaware of any utility in the State that had achieved <u>net</u> remaining restructuring benefits after elimination of strandable costs exceeding its annual electric revenue requirement, as Central Hudson has attained (Tr. 1296).

1. <u>Other Parties' Positions</u>

Staff and MI oppose Central Hudson's request on similar, not identical, grounds. Mr. Mavretich also opposes in his letter dated February 14, 2001 and CPB provides a footnote in its initial brief stating its opposition.

Staff seeks to de-construct Central Hudson's request by separately addressing four sources of funds, without ever confronting the combined effect of Central Hudson's restructuring actions. In contrast to Staff, although MI also asserts that

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[5] This "excess earnings" amount is already net of a $6.9 million reduction previously <u>requested</u> by Central Hudson. The effect was to give to customers $6.9 million of the shareholders' excess earnings.

[6] The amounts requested by Central Hudson would be much lower in comparison to the total benefits of $799 million in total benefits, amounting to 2.9% or 0.6%, respectively.

Central Hudson's shareholders should not receive any participation in the benefits (MIIB 24 et seq.), MI at least acknowledges the significance of the benefits produced by Central Hudson.[7]

Staff first addresses funds generated by the fossil auction and says that the Commission has already determined that any excess belongs to ratepayers in its Auction Approval Order and Auction Clarification Order. As to the NMP2 sale proceeds (net of costs), Staff merely observes that the final amount is not known with precision, but never articulates a position (SIB 5) on the treatment of those funds. As to the group of "mitigators" established in the Restructuring Settlement Agreement, Staff dismisses Central Hudson's requests as "unjustified" and asserts that the Commission "directed in the Opinion No. 98-14 RRP that these funds be returned to ratepayers." Staff's fourth "source" is the excess earnings specifically deferred for the purpose of mitigation of strandable costs. Staff asserts that the Restructuring Settlement Agreement provides that these funds will be returned to ratepayers and claims that Central Hudson's "theory...has already been rejected...." Staff, disparaging Central Hudson's "theory" as being "half-baked,"

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[7] To underscore their significance, the first several sections of the MI Initial Brief are devoted to addressing the benefits. For example, MI, in addressing the auction proceeds realized by Central Hudson, describes them as "substantial" (MIIB 5), or representing "hundreds of millions of dollars" (Id. Note 6). MI also acknowledges the $38.7 million (MIIB 6) of the Restructuring Settlement Agreement deferrals as well as the NMP2 sale (MIIB 19 et seq.), the fossil auction TPA (MIIB 10 et seq.) and the NMP2 PPA (MIIB 20-21).

resorts to mis-describing it, alleging that Central Hudson:

> "maintains that the [Restructuring Settlement Agreement] was designed on the assumption that strandable costs would exist, while the possibility of stranded benefits was not contemplated."

Staff then presents four arguments. First, it argues that the Commission rejected this "theory" in the Auction Approval and Auction Clarification orders. Second, Staff continues, referring to the "auction incentive" provision, to state that the Restructuring Settlement Agreement "provided for the disposition of benefits, even where their magnitude was large."[8] Third, there is no "potential" benefit to ratepayers. Fourth, the disposition was established in the Restructuring Settlement Agreement. Central Hudson, Staff alleges, is "dissatisfied with the balancing" and Central Hudson, having received protection from "downside risks," "cannot argue that those protections were valueless."

MI's position roughly parallels Staff's position. MI contends (MIIB 29) that providing some sharing to Central Hudson (a) is "unnecessary;" (b) would "improperly" reward the Company

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[8] Central Hudson attained a sales price for its fossil assets that equates to 4.6 times the book cost of the assets (Tr. 1149, 1287). This return significantly exceed the realizations by the other Roseton co-tenants as a result of an agreement achieved by Central Hudson with the other co-tenants that has advantaged Central Hudson's ratepayers. Staff is noticeably silent on this aspect of Central Hudson's performance, which was not underwritten in any way by its ratepayers but redounds to their benefit.

for prior performance; (c) would be "duplicative of the share-holder incentive associated with the fossil plant auction;" and (d) would be "unsupported by, and inconsistent with," the Settlement Agreement and the Commission's orders approving the Settlement Agreement. CPB acknowledges the significance of the benefits produced for ratepayers (CPBIB 32) but refuses to support sharing by the Company in the benefits it has produced (CPBIB 31, notes 89 and 91). Mr. Mavretich generally offers commentary on the evidentiary presentations of other parties (he offered none) and seeks to characterize Central Hudson's rebuttal presentation as "improper." He claims that seeking recovery of the excess earnings is contradictory to earlier Company statements and attempts to bring before the Judge extra-record material consisting of the economics of NMP2 as described according to Mr. Mavretich's "spin" on extra-record "studies."[9]

2. Discussion

It is unfortunate that Staff mis-understands Central Hudson's position.[10] The Company, however, has not stated that

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[9] Central Hudson objects to any consideration of Mr. Mavretich's 11/28/00 comments in Case 96-E-0909; they could have been offered by Mr. Mavretich for the record in the instant case, but he chose not to offer any evidence and may not now seek a back door into the record. Furthermore, Mr. Mavretich grossly inflates the alleged reliability of the NMP2 "study" he relies upon. Since Mr. Mavretich avoided offering any direct evidentiary presentation, his belated attempts at presenting "facts" that the Company disputes as unreliable should be dismissed.

[10] The same mis-understanding may have affected the Commission's Auction Approval Order.

the production of any net benefits ("stranded benefits") after elimination of strandable costs was not contemplated as a potential outcome, as Staff mistakenly asserts. Instead, strandable costs were viewed as being the most likely outcome and stranded benefits of some, probably nominal level, were viewed as being a far, far less likely outcome; and most significantly, an outcome of hundreds of millions of <u>net</u> stranded benefits was entirely unanticipated.[11] Central Hudson witness Upright carefully explained exactly what the parties anticipated:

> The parties to the Settlement Agreement worked diligently to balance the interests of customers and shareholders. Each group sacrificed current benefits in order to mitigate future stranded costs. In the Settlement Agreement, the sale of the fossil generating plants was intended as mitigation of strandable costs. All parties anticipated that most likely there would be stranded costs still to be recovered from customers after the fossil generating plants had been auctioned. The Settlement Agreement does address the possibility that there would be an excess of funds available after writing off the Nine Mile 2 plant, but the parties' discussions of

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[11] Central Hudson's requests for sharing in the benefits rest on the fact that the results it has produced are both superlative and unanticipated. Central Hudson attained a sales price for its fossil assets that equates to 4.6 times the book cost of the assets (Tr. 1149, 1287). The total gross benefits produced are over $799 million, or 84% of Central Hudson's pre-restructuring total capitalization for electric ratemaking purposes, as last determined by the Commission in 1993. Central Hudson has restructured in a way that has produced net remaining benefits of $153.3 million (net of tax), or over $300 million pre-tax, after eliminating strandable costs. Neither the signatories to the Restructuring Settlement Agreement nor the Commission anticipated the creation of very significant net benefits <u>after</u> elimination of strandable costs.

> that possibility were in the sense of completing the logic of specifying the potential uses of the funds rather that establishing an expectation. We all now know that Central Hudson does not have any stranded costs to collect from customers, and, in fact, has a significant pool of stranded benefits. This result is different than what was expected and it far exceeds the parties' expectations. (Emphasis added.) (CHGEIB 14; Tr. 654)

Staff had the opportunity of questioning Mr. Upright about his statements, had Staff had any disagreement with them, but Staff chose not to make any inquiry on the record. Central Hudson explained its view in its Initial Brief (CHGEIB 14):

> While the Restructuring Agreement anticipated a possibility that some net benefits might be produced, nothing in the Restructuring Agreement provided a basis for assuming that Central Hudson's anticipated divestiture of its fossil generation assets and its other operations under the Settlement Agreement would lead to the creation of the hundreds of millions of dollars in benefits that have actually been produced. The key is not just that there were net benefits produced, but that the level of net benefits produced "far exceeds" expectations.

Staff attempts to stretch the Commission's Auction Process Order's adjustment of the "auction incentive" into a determination that "diverting more than [the capped amount] from ratepayers" would be unreasonable. The so-called Auction Process Order was, however, issued in February 2000; well before the auction results were known. Furthermore, the Auction Process Order addressed a quid pro quo for the surrender of the right of Central Hudson's affiliate to bid in the auction. If, as Staff contends, the cap in the Auction Process Order was a determination that "diverting" any greater amount would be unreasonable, that determination only applied to the purpose of compensating Central Hudson's affiliate for surrendering a right it held. That Order simply does not purport to be a determination that no other compensation would necessarily be inappropriate based on conditions then neither known nor before the Commission. Staff's weak attempt at inflating the Auction Process Order into a different determination that the Commission never made illustrates the lack of basis for Staff's position.[12]

Staff then tries to use the Auction Approval Order's procedurally dubious, pre-emptive attempt at denying relief to Central Hudson (SIB 7-8) to claim that the Commission "found" that there was a potential for realizing "substantial benefits from the fossil auction" that was contemplated in the Restructuring Settlement Agreement. This Staff argument addresses Staff's own mis-characterization of Central Hudson's position as including the concept that "the possibility of stranded benefits was not contemplated." In fact, as noted above, Central Hudson

[12] Contrary to Staff's contention on brief, that "the auction incentive reasoning adheres to the disposition of all the benefit pools" (SIB 8), the Auction Process Order did not even address those "pools," to use Staff's term. Nor did the Commission then have before it the present facts concerning the significance of the net benefits Central Hudson produced. So, Staff's contention that the Commission erected a barrier to a matter that was not then before it would be inappropriate agency decision making, had it occurred, but the Order relied upon by Staff gives no indication that it did occur.

has acknowledged that the Restructuring Settlement Agreement addresses a "possibility" of stranded benefits as exactly that, a very low probability possibility at a level, if achieved at all, of nominal dimensions; what the Restructuring Settlement Agreement does not address is the actuality of hundreds of millions of dollars of net stranded benefits, after recognition of taxes, costs of the transactions and the elimination of strandable costs. Notably, Staff never offered its own witness to state, under oath, what the parties to the Restructuring Settlement Agreement actually anticipated.

Staff contends that Central Hudson's request "comes too late after the purported benefit" (SIB 8). This astounding argument attempts to penalize Central Hudson for not having foreseen the bonanza its efforts have produced. In reality, however, Staff's argument makes Central Hudson's point that the actual outcome was not foreseen. Staff's related argument that the benefits have actually been achieved, so that there is "no potential benefit to ratepayers" (SIB 8), is equally devoid of content and reflects an unreasonable, "heads I win, tails you lose" attitude.

Staff's contention that Central Hudson is "dissatisfied with the balancing" under the Restructuring Settlement Agreement again shows Staff's mis-understanding of Central Hudson's position. As Mr. Upright stated, without any dispute or question by Staff, Central Hudson seeks to implement, not alter, the balancing principles of the Restructuring Settlement Agreement in the context of a situation not previously envisioned:

> I believe that my proposals have all been geared to attaining and maintaining the balancing of interests inherent in the Settlement Agreement under circumstances that were not anticipated in the formation of the Settlement or its approval by the Commission. Since ratepayers have been relieved of their obligation to pay for stranded costs, shareholders too should be relieved of their obligation to mitigate stranded costs and have their deferred excess earnings returned to them (CHGEIB 15-164; Tr. 655-656).

The settling parties, including Staff, made representations to the Commission that influenced the Commission's adoption of the Restructuring Settlement Agreement, which it did not do in a vacuum. Staff, in now attempting to hide behind the Commission's Opinion 98-14, may not, however, so easily walk away from the mutual concessions and obligations that are "baked-into" both the Agreement and the Opinion. All knew that Central Hudson was undertaking the most serious restructuring of the company in reliance on the mutual commitments and expectations. All now should be supporting those principles, as is Central Hudson.

Furthermore, the argument that Staff seeks to use as a sword against Central Hudson can be applied with equal force against the interests Staff seeks to protect: in both instances an "opportunity" to recover either strandable costs or benefits was all that was provided. Quite obviously, Central Hudson's modest requests to receive a small portion of the net benefit pool does not imperil the "opportunity" for receipt of the vast bulk of the stranded benefits by ratepayers that, even after granting Central Hudson's request, will exceed expectations.[13]

Only brief response need be offered to Mr. Mavretich's gripe that Central Hudson is somehow inconsistent between its statements in Case 96-E-0909 and in this case. In 96-E-0909, Central Hudson made the point that it had lost the cash flow benefits of the excess deferred earnings that were deferred under the Restructuring Settlement Agreement. It was in that sense that those monies could not be recaptured. Mr. Mavretich has, however, sought without basis or justification to construct Central Hudson's statements into something different and entirely unintended; namely, a bar on its alternative request here for return of the deferred excess earnings amounts.

3. Conclusion

Central Hudson's request is not being presented in the context of an outcome of near-zero net benefits, but in the

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[13] The contention that a phrase in Attachment B to the Restructuring Settlement Agreement controls the entire body of the Agreement is unconvincing. The parties did not intend that the Attachment would control the disposition of the excess earnings. Instead, they provided that the "excess earnings" were for the specific purpose of mitigating stranded costs, a purpose that now is not meaningful. That Attachment B is not controlling is confirmed by note 1 of the Commission's April 28, 2000 approval of Central Hudson's request concerning storm costs in which the Commission stated that the excess earnings were deferred "for future disposition."

context of benefits far exceeding any rational expectations. What Central Hudson requests is not to upset the Restructuring Settlement Agreement, but to apply its' principles of sharing to the actual outcome that is so highly successful and beneficial to ratepayers. The Company has requested a small portion (less than 3%)[14] of the benefits it produced. This request should be granted.

C. Other Uses of Benefits

Assuming that Central Hudson's request is granted, the remaining net benefit fund amount would be $129.9 million ($153.4 less $23.4) or $148.2 million ($153.3 less $5.1); in either case, a significant amount of money for Central Hudson's customers. The parties expended much more effort in arguing against Central Hudson's modest request than in addressing the disposition of the much larger net remaining $130 to $150 million fund, but a few proposals warranting discussion have been made.[15]

Common to all of these proposals is, however, the absence of consideration for a mechanism to protect Central Hudson's financial integrity. Such a mechanism is necessary should the rate base credit approach espoused by Staff witness Roby be

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[14] [$23.4/($799 + $100)]*100%=2.6%

[15] Staff, for example, devotes four and a half pages to attempting to assure that Central Hudson receives neither $23.4 million or even $5.1 million for producing the benefits and about two pages addressing the disposition of the $130/150 million remainder.

adopted, because that approach would credit customers with the full amount of the remaining benefits, but entail cash obligations on Central Hudson to fund the actual use, or draw-down, of the credits on some as yet unspecified schedule. Since Central Hudson has utilized the cash from the fossil sale transactions, as it has been authorized to do, it will be necessary for the Company to borrow money for the purpose and the financing costs should also be debits against the rate base credits that are pre-approved as deferred items with carrying charges (under Mr. Roby's approach at the full return recommended) for subsequent recovery in rates.[16] It should be noted that if the carrying charge approach recommended by Company witness Upright is adopted, that method is "self-correcting" in the sense that, as funds are utilized, the balance against which carrying charges is applied will be reduced.

1. Retail Competition Enhancements

The marketer parties in this case, SPM and SCMC, have advocated a number of "enhancements," which they contend will further retail competition.

SPM proposes (i) that the utility bear the costs of ancillary service and spread them across all customers and (ii) that the utility provide a single bill option. SCMC takes a

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[16] Mr. Roby (Tr. 1226) acknowledges that the Commission can protect the Company from economic injury.

similar position concerning ancillary services (SCMCIB 8-11). Staff opposes both of the ancillary services proposals and the single bill proposal. Central Hudson does not object to the ancillary service proposals, but opposes the single bill proposal.

SPM also proposes payments of $75 per customer directly to the ESCO as well as smaller payments to the customer, for each customer that switches from Central Hudson to an ESCO. SCMC, which filed no testimony, on brief seeks establishment of a number of "enhancements" (SCMC 11 _et seq._), including one time switching payments of $30 per customer, payable directly to the ESCO; electric "commodity" credits of 7 mills or 5 mills per kWH; and a merchant gas credit of 8% of Central Hudson's transportation rate.

Staff opposes making a payment directly to the ESCO and offers, for the first time on brief, that a one-time payment of $75 per customer, paid directly to the customer, be established. Central Hudson agrees with Staff that if any payments are authorized, they should be made directly to the customer, and not to the ESCO. However, there is no record basis for Staff's proposal on brief for a $75 payment and no payment program should therefore be adopted without further discussion of the necessary mechanics and provision for recovery of all of Central Hudson's administrative costs.

An additional concern is that any payment program have a reasonably reliable basis for believing that the payments will lead to the intended result. Thus any payment program should not be intended just to encourage customers to leave Central Hudson's provision of "commodity," but to encourage customers to stay off Central Hudson's provision of commodity. Central Hudson recalls earlier programs for payments to encourage the use of solar equipment. Although well intentioned from a policy perspective, implementation led to actions fairly described as generally short term in nature. Central Hudson is prepared to work towards the development of a sound program of additional enhancements to facilitate the Commission's competitive vision through a functional and appropriate direct payment to customers.

Staff's proposal to fund $2 million annually from the net benefits (SIB 83) is not objected to by the Company.

SPM proposed a "migration" incentive and Central Hudson agrees with Staff (SIB 84) that it should not be implemented.

2. <u>Electric Market Price Spike Mitigation</u>

Staff supports, at least in very broad outline, a rather generalized proposal made by CPB to mitigate month to month and year to year electric price increases (CPBIB 29 <u>et seq</u>.; SIB 84-5).

Central Hudson does not object in principle to development of an economically appropriate mechanism to dampen the effects of extreme price movements caused by dis-functionalities in an otherwise workably competitive market, provided that a substantial price signal remains for customers. The difficulty is that such a mechanism is complex and none has been developed by any party to this case. The price discounting approach proposed by CPB is not economically justifiable because it would shield customers from true levels of market price and thereby lead to inappropriate over-consumption, or at least failure to reduce usage at a time when it is known that a desirable supply/demand balance does not exist in the NYISO markets under certain conditions.

In addition, the availability of the TPA and NMP2 PPA will provide significant wholesale price protection to Central Hudson's consumers in the next three years. Therefore, there is time to permit discussions leading to development of a suitable approach.

In the immediate future, however, the further, broad price discounting along the lines outlined by CPB would run counter to the Chair's recent statement that "Customers who elect to modify their usage in response to price changes not only benefit themselves, by reducing their costs, but they will also help stabilize and reduce prices for consumers in the broader market." Development of a mechanism to dampen upward price spikes, not eliminate economic price trends, would probably better take place two to three years from now, as the TPA is ramping down (although the NMP2 PPA will remain in place for a total of ten years, it is for only about 80MW). Conditions then may well be significantly different from today's conditions, so that attempting to develop a mechanism today, in anticipation, would be wasted effort.

3. Refund

Central Hudson is opposed in principle to any refund to today's customers that exceeds the "sharing" provided to Central Hudson in this proceeding. Any refund must be a separately stated item on the bill and not included in base rates.

Similar considerations of "inter-generational equity" that were relevant to the treatment of the costs of financing the generating plants are relevant to consideration of refunds. There is no practical way to prevent the customer who arrived last week from receiving the same refund as the customer who has been a Central Hudson customer for thirty years.

Central Hudson opposes the extreme refund position of MI.

4. Reliability Enhancements

Staff proposes that its cut-down version of Central Hudson's proposed reliability enhancement program be funded out of the net benefit pool. This approach would mean that Central Hudson would receive no compensation (other than recovery of its expenses) and is not acceptable to Central Hudson. The Company took the initiative to develop the program and, despite the criticisms from Staff, Staff continues to recognize that the program has merit. If the program proceeds at any level, Central Hudson should have a reasonable opportunity of earning a profit on its efforts. If, for example, the Commission were to engage a consultant to do the final project, that consultant would demand a profit and Central Hudson should receive no less.

5. Allocation of Fossil Sale Gain to Gas Operations

SPM proposes that the historical common allocation ratio (13% gas/87% electric) be used to apportion "the divestiture gain" (SPM 10) between gas and electric operations. Central Hudson does not agree. The common allocation ratio has been used for costs that were not easily assignable between gas and electric operations; not for allocations of electric generating plant. Furthermore, gas operations will receive adequate benefit through the use of a portion of the gain to offset gas site remediation costs under the approach recommended by Staff (SIB 35-36), to which Central Hudson does not object.

III. CUSTOMER SATISFACTION AND INCENTIVES

A. Basis for Incentives

The basis for Central Hudson's entire approach to incentives was the proposition that it should be subject to incentives that reflect those provided by competitive markets and common human experience in that a range of "acceptable" performance would be neither rewarded nor penalized; performance that falls below the "acceptable" range would be penalized and performance above the range would be rewarded (CHGEIB 34-35). The Company believed that establishment of market-like incentives was also consistent with the Commission's pro-competition initiatives.

Although Staff's brief states that "Central Hudson's proposals are acceptable as a starting point" (SIB 64), in fact Staff did not employ Central Hudson's proposals as a starting point (Tr. 1065-66) because Staff categorically rejected the symmetrical, market-like foundation of Central Hudson's proposal.

Despite attempting to gloss its proposals by paying lip-service to Central Hudson's presentation, Staff's antipathy to providing Central Hudson with the potential for being rewarded for superior performance is manifest. The basis for that antipathy, however, was never stated; the closest statements on brief seem to be those in which Staff disparages positive incentives as occurring "at the expense of customers" (SIB 63) and raises the specter that a utility "might overspend at the expense of ratepayers" (SIB 64). These rationalizations cannot survive analysis. First, the premise of incentive ratemaking should be that there is value created from the conduct that the incentive seeks either to bring about or, alternatively, avoid. It is no answer to the question of whether there should be positive incentives to say, as in Staff's brief (SIB 63, 64) that the quantification of a positive incentive might be incorrect; the same is true of negative incentives. Obviously, the quantification must also be done correctly, but the quantification issue goes only to the method of implementation, not to whether the kind of incentive should be utilized at all.[17] Second, Staff's "increased expense" justification does not follow. If the utility expended funds not provided for in the ratesetting process to achieve a positive incentive, those expenditures would most assuredly be for the account of shareholders, not ratepayers. If Staff were assumed to be correct that increased expenses to attain a reward would be at the expense of customers, then it would follow that increased expenses to avoid a penalty would also be at the expense of customers. Staff's argument, therefore, would lend no support to

[17] Of course, it is possible that Staff has observed Central Hudson's continual improvements and has, somewhat cynically, judged that the Company's desire for improvement is so deeply ingrained that Staff and the Commission need not support positive improvements financially. While sufficient explicit information is not available to state definitively that Staff actually harbors this view, Staff's current efforts at "pushing up the floor" on various performance measures lend credence to the proposition in that, by that approach, Staff could achieve better performance without financially supporting better performance. Thus, Staff's statement on brief that "the purpose of the incentive is to maintain that [satisfactory] level of service and discourage deterioration" (SIB 64) could actually be conveying an intent, over time, to continually push up the floor and place the Company at ever increasing standards of performance and ever increasing risk of financial penalty.

its position that positive incentives should be avoided in preference to penalty-only mechanisms, even if it were correct.

With respect to Staff's "trigger" levels for the one-sided penalties Staff proposes, Central Hudson has two objections. Staff continues to arbitrarily raise the floor for the CSI "trigger," now to 83.0, even though Staff agreed that it represents "satisfactory" performance (Tr. 1060-1061). There was no empirical basis for pushing up the floor presented by Staff and Staff's rationalization that the Company has done better in the meantime since the 83.0 level was agreed to represent satisfactory performance fails to address the basis for utilizing the improved performance as a trigger level for a penalty. The penalty trigger level is supposed to represent the start of unacceptable performance; that better performance may have occurred is not relevant to determination of the "unacceptable" level of performance and, as noted above, Staff offered no empirical basis for a determination that falling below its 83.0 level represented "unacceptable" performance.

In short, although Staff acknowledges that Central Hudson's performance virtually across the board has improved over the past few years to the point where Central Hudson is at or near the top among New York utilities in virtually every category, Staff does not offer any reward to the Company. Instead, Staff "re-baselines" Central Hudson's financial risk in light of it being at the top of the pack. This unfairly subjects Central Hudson to penalty risks not borne by other utilities for equivalent performance. Central Hudson asks that Staff's proposals not be recommended to the Commission.[18]

Incentive ratemaking should be premised on an underlying policy foundation so that the techniques by which the policy is implemented may be assessed with respect to their consistency with, and furtherance of, that policy. Only then can fairness and reasonableness be the result. As shown above, Staff's proposals are not guided by any discernable incentive ratemaking policy. Instead, they may fairly be described as a collection of independent extraction devices. The Company's incentive plan proposals have a policy foundation that has not been discredited in this proceeding. Its soundness is evidenced by the way it was avoided rather than addressed. The techniques by which the Company proposes to implement the policy are all in furtherance of the policy and, unlike Staff's proposals, do not suffer from internal inconsistencies. The Company's incentive plan proposal should be approved.

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[18] Central Hudson also objects specifically to Staff's proposal that the Company be placed at risk of penalty absent a 25% improvement with respect to repairing gas system leaks (SIB 73-74) even though the Company's performance is satisfactory under the Commission's rules (Tr. 162; CHGEIB 53-54) on the ground that such proposal, in addition to being factually unjustified, conflicts with the substance of the rule.

B. PSC Complaint Rate

The Company (CHGEIB 48-49) exposed the lack of substance to Staff's initial testimonial assertion that it is necessary to add the PSC Complaint Rate to the incentive program to cure imbalance and invalidity resulting from the fact that the Customer Satisfaction Index ("CSI") is calculated and reported by the Company. That argument is noticeably absent from Staff's initial brief. Actually, however, Staff does an about-face in its brief and advances the more aggressive proposition that the PSC Complaint Rate must be included along with the CSI "[n]o matter how scrupulous the utility is in conducting its surveys that underlie the CSI" (SIB 67). The reason now offered is that "[p]ublic perception requires that use of the CSI be balanced by a measure outside the utility's control" (SIB 68), but no data were offered by Staff to support this "public perception." In other words, although Staff is now forced to acknowledge that on cross examination its witness could not sustain any real fault with Central Hudson's CSI measure, Staff now abandons its testimonial position in favor of a novel unknown and unsubstantiated "public perception" rationale.

Staff's new rationale, like the old, does not hold up under scrutiny. While Staff invokes this public perception rationale with respect to the Company's role in connection with the CSI, it does not raise this public perception issue in connection with any of the several other incentive measures it proposes or otherwise supports that are no less subject to measurement and reporting by the Company.[19] Because the CSI is indistinguishable from the other incentive measures in this regard, Staff has either missed several boats or, as is more likely, there were no boats at all.

On the other hand, with respect to the matter of "balance" in the measuring and reporting of results, the Company may not unilaterally change the established incentive measurement and reporting methods it performs and <u>its</u> books and records are open to independent scrutiny without the objections raised by Staff about equivalent Central Hudson review of the Complaint Rate. PSC Complaint Rate measuring and reporting, however, is not subject to the same scrutiny by Central Hudson and Central Hudson understands that active consideration is currently being given by Staff to just such a change involving potential replacement of "complaints" with a new system of recording "contacts."[20] The Company believes that these distinguishing

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[19] These include SAIFI, CAIDI, Keeping Scheduled Appointments, Gas Leak Management, Gas System Damage Control and Interruptible Gas Profit Imputation.

[20] Moreover, if the PSC Complaint Rate does become an incentive measure for the Company, it should be under the condition that it will cease to be so immediately upon any change to the now existing rules or procedures by which it is measured

features make Staff's criticisms of the Company's measure unjustified and the PSC Complaint Rate an unsuitable incentive plan component.

C. Customer Satisfaction Through Improved Reliability

1. Capital Improvement Program

Staff testified at length as to the merits of the Capital Improvement Program ("CIP") and concluded that it should be pursued because it would produce "substantial" and "warranted" improvement in reliability (Tr. 1388-1392). Consistent with this testimony, Staff's initial brief states concurrence that the CIP has merit in terms of producing the desired reliability improvement (SIB 22, 70). Although Staff expresses this view, Staff's initial brief contains discussion, including a departure from its testimony, that if followed would unnecessarily delay and limit, if not prevent, realization of the CIP's benefits by customers.

a. CIP Evaluation Processes

Staff testified that the only reservation preventing it from recommending that the CIP as proposed by the Company be approved was whether Company "processes for approving large capital projects...[are] adequate" for the CIP, referring specifically to the need for additional information regarding how projects are "evaluated and approved under the capital budget

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or upon its replacement by any other form of substitute or alternative of similar purpose.

process" (Tr. 1391-1392). Staff, however, had incorrectly "assumed" that the Company's "capital budget process" would be applicable to the CIP (Tr. 295; Ex. 16, Sch. B).

On brief, Staff continues incorrectly to identify the review and management process that would be applicable to the CIP as the Company's "standard review process" and states its belief that "special procedures tailored to the [CIP]" should be established (SIB 22). The Company has established, and has explained on the record of this proceeding, special procedures tailored to the CIP of the nature Staff believes are necessary (Tr. 295-297; CHGEIB 37). Staff does not indicate that these special procedures are also inadequate but, rather, signals the opposite by not challenging them in any way.

The special review and management procedures that the company will apply to the CIP are appropriate and provide assurance that the CIP will be implemented as proposed. Consequently, there is no reason to delay realization of the benefits of the CIP by following Staff's suggestion (SIB 23) that implementation of the CIP be delayed until these procedures are established in "the compliance phase" of this proceeding. They have been established and Staff's opportunity to review them has not resulted in any objection.[21]

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[21] Perhaps with its vague reference to "an adequate procedure for evaluating the projects identified as potentially beneficial" (SIB 22) and in the absence of any mention of the

b. CIP Funding and Duration

With Staff's only issue resolved as discussed above, Staff's position is, or should be, agreement with the CIP as proposed by the Company. Nonetheless, Staff proceeds on brief (SIB 23) to recommend some different version of the CIP. The parameters of that different version are very unclear, and the very concept of altering the CIP is inconsistent with Staff's own witness' endorsement of the contents of the Company's submission.

With a vague reference to establishing a multi-year program within the context of a one-year rate proceeding, Staff now says that CIP funding should be limited to $6 million comprising $5 million of capital costs and $1 million of expense.[22] It is not clear, however, whether Staff's newly minted version of the CIP is a one-year program of $6 million or whether the three-year feature of the CIP Staff previously said

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"capital budget process" Staff is raising a different evaluation concern than that raised in its testimony. If that is the case, Staff raises no legitimate issue for later resolution. Staff reviewed the Company's proposed technical processes for evaluating and then selecting projects for inclusion in the CIP (Tr. 1388-1389) and found that the adequacy of those procedures was demonstrated (Tr. 1391).

[22] Staff incorrectly describes the expenses as being for "implementation and evaluation" associated with the CIP. The funding of expenses is actually to provide for activities that, although properly accounted for as expense, are undertaken in connection with the capital improvements themselves such as transformer installation and removal, among others (Tr. 284-285).

should be pursued remains but with funding at only $6 million per year. In either event, Staff inappropriately departs on brief from its testimony that the CIP as proposed by the Company (three years with per year funding of $11 million including $1 million of expenses) should be pursued.

According to Staff's testimony, the CIP as proposed by the Company "will provide the desired results" (Tr. 1389) and "is sound and will provide customer benefits in terms of enhanced reliability and long term improvements to the distribution system infrastructure" (Tr. 1391). Staff, however, is not free to abandon its evidentiary presentation in favor of some new contradictory proposal that would undercut its testimonial conclusions.[23]

As to whether Staff's new CIP is a one-year or a three-year program, no support for curtailing CIP benefits to those that can be attained in one year can come from this proceeding resulting in rates being set for a single rate year. This is especially so in light of Staff's suggestion (SIB 23) that the CIP be funded out of the "benefit pool" rather than reflected in the revenue requirement. There is no novelty to establishing a multi-year program in a proceeding that addresses a single rate

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[23] Staff's funding curtailment appears to be either approximately 45% ($18 million vs. $33 million) or approximately 82% ($6 million vs. $33 million).

year. In fact, this proceeding itself contains other multi-year proposals with which Staff does not take issue. For example, Staff concurs with the Company's proposed three-year term for a low income program (Tr. 968) and has itself suggested a reliability improvement incentive structure that proposes the Company be penalized if does not attain annually graduated reliability improvement in each of the next three years (SIB 70).

c. Reliability Incentive

Although Staff now appears to be prepared to curtail the benefits of the CIP by severely reducing funding, it fails to recognize the consequences of those curtailments in relation to its proposals to penalize the Company if certain reliability targets are not met. Staff initially tied its proposed reliability performance penalty mechanism directly to the anticipated 15% SAIFI improvement of the CIP as it was proposed by the Company (Tr. 1394; Ex. 131). In the face of its briefing position that the CIP expenditures be substantially curtailed, Staff (SIB 70) astoundingly maintains its initial proposals for reliability targets and related penalties based on the 15% SAIFI improvement. Staff offers no justification for assuming that the "high level of service the expenditures are supposed to achieve" (SIB 70) remains the same regardless of whether the expenditures are $33 million, $18 million or $6 million. The absence of a justification for this inconsistent position is not surprising - none exists.

Moreover, if it is determined that there is a need for further development of evaluation processes of some form in a "compliance phase" of this proceeding or any other unresolved issue delays funding, and consequently implementation, to a point beyond the beginning of the rate year, then such delays should be recognized by appropriate adjustment to reliability incentive program features.

Staff resists recognizing the effect of the recently installed Outage Management System ("OMS")[24] on reliability performance indices by re-calibrating the indices.[25] Although Staff has presented no basis in fact or principle for overcoming the concerns with implementation of the OMS that the Company has identified, Staff's omissions simply would ignore them. It is not acceptable to establish the incentives with the knowledge

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[24] The OMS is a computer based information system that incorporates specific circuit information, more precise customer location information and will allow better and quicker identification of the specific portions of the Company's system affected by an outage and the number of customers affected. The OMS system will have the effect of increasing the <u>reported</u> duration of outages, the <u>reported</u> frequency and the <u>reported</u> number of affected customers, assuming <u>identical</u> outage patterns pre- and post- OMS.

[25] CPB opposes the Outage Management System by mentioning that several generic proceedings are pending (CPBIB 14-15). Akin to its position regarding the CIP and pending generic proceedings (CPBIB 23), CPB merely speculates that some undefined problem might arise and then sits back. The Company does not have that luxury when it comes to operating its business and it does not share CPB's alarm in connection with these generic proceedings (Tr. 163-164). Moreover, CPB overlooks the nearly complete status of the Outage Management System (Tr. 163) and provides no basis for refusing to recognize an improved operating system.

that an unsolved problem exists, as Staff proposes. The problem should be fixed before, not after, any incentives keying off OMS data are established. Staff's suggestion that this can be done at a later time, if necessary, when better information is available (SIB 71) is not acceptable because Central Hudson would already be at financial risk from a program, under Staff's approach, that already would include a flaw.

2. Enhanced Line Clearance Program

The validity of the Company's point that Staff's review of the Enhanced Line Clearance Program ("ELCP"), unlike its review of the CIP proposal, labored under a fundamental lack of understanding and misapprehension of the ELCP and its effects (CHGEIB 39-40), is underscored by Staff's initial brief. Staff unavailingly attempts to discredit the ELCP by first trying to avoid the significance of the success of the ELCP pilot program performed by the Company and then by lashing back at the ELCP.

Staff's criticism of the ELCP is that it is not properly focused in that it wastefully will be applied to all 7,300 miles of the Company's distribution line (SIB 13). This is simply not true.

Staff also says that, like the pilot program, a "proper program for enhanced trimming would target towards areas where the risk of tree-related damage is especially high" (emphasis added)(SIB 13). This is true. As Company witness Freni has explained, the ELCP will "target[] the removals of those trees or limbs that offer the most potential reliability <u>benefit</u>"; the Company will "<u>select</u>[] the locations and techniques that would most cost-effectively achieve the <u>desired results</u>"; trees "<u>identified</u> as a reliability <u>threat</u>" will be removed; and the ELCP "would be <u>directed</u> toward those portions of the system that pose the <u>highest risk</u> to cause outages for the largest number of customers" (emphasis added)(Tr. 286-289).

Therefore, even though Staff inexplicably appears to have not noticed the underlying principle of the Company's ELCP, that principle is clearly precisely what Staff says would define a "proper" program.

Central Hudson showed that Staff was inconsistent (Tr. 307; SIB 14). For the ECLP, Staff asserts that alleged productivity savings from the ECLP should be recognized,[26] but for Staff's proposal to require additional work effort for Type 3 leak repair, Staff refused to recognize the incremental labor requirement. On brief (SIB 14), Staff claims that it has a "source" for the Type 3 leak work effort; namely, Staff's productivity adjustment. It is incorrect, however, to "assign" a

[26] Staff's prescription of broad labor savings itself was severely undercut by unrefuted Company testimony on cross-examination establishing that the only <u>potential</u> for savings was from tree related outages, occurring at night, but only after midnight and not during storms (Tr. 318). Obviously, forecasting the likelihood of savings under these narrow circumstances is speculative at best. Staff's witness, however, incorrectly presumed that there <u>would</u> be savings and, on brief, Staff attempts to force Central Hudson to prove a negative. The uncontradicted testimony of Company witness Freni (Tr. 318) does so to meet Staff's unreasonable presumption.

productivity adjustment to a mandated work effort, because the concept of a productivity adjustment is to leave it to the Company to discover the ways of improving its operations to reduce costs. Since Staff's Type 3 repair program represents an <u>increase</u> in costs, Staff's position on brief means that Central Hudson would have to find <u>even</u> <u>more</u> labor savings elsewhere in its operations and, in effect, further increases Staff's already bloated productivity adjustment.[27] It is, moreover, wrong in principle for Staff to assert that a "source for the increased staffing costs" of Staff's proposed Type 3 repair program could be funded by a <u>reduction</u> in the labor force or by a reduction in the overall allowance for expenses. Thus, Staff's attempt on brief is unavailing to excuse its inconsistent treatments.[28]

As the Company has explained, and no party has meaningfully challenged, the ELCP is a well-planned program that will cost-effectively produce electric system reliability improvements for Central Hudson's customers (CHGEIB 35-36, 38-43). It should be approved.

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[27] Recall that, to produce greater impact on Central Hudson, Staff would apply the 1% factor to the Company's <u>higher</u> labor level; and not consistently with Staff's own <u>lower</u> recommendations.

[28] MI did not provide testimony with respect to the ELCP but on brief follows, in all material respects, the testimony of Staff witness Walter. The points in the Company's initial brief on this subject, therefore, are applicable to MI's position on brief.

D. Payment By Credit Card

The opportunity of paying by credit card is ubiquitous for Central Hudson customers. They may now use a credit card to pay by telephone, over the Internet and in the more traditional over-the-counter and through the mail transactions. They may now use a credit card in circumstances in which they traditionally could not. These include payments to local governments, New York State (Department of Motor Vehicles) and the federal government (IRS) (Tr. 145). There is no reason to exclude this option when the time comes to pay a Central Hudson bill, as the Commission has permitted for payment of a Consolidated Edison bill (CHGEIB 61).

It is instructive to compare Staff's support of establishing a low income program to its objection regarding credit cards.[29]

Staff points to the costs of the credit card program of $365,000 in the rate year (SIB 37). Staff's estimate of Low Income Program Costs is $401,000 for the rate year (CHGEIB App. B).

Staff points to the costs of the credit Card program "nearly quadrupling" by the third year (SIB 37) to $1,390,000 (Ex. 4). Staff's estimate of Low Income Program costs shows them

[29] The Company endorses establishing a Low Income Program as well. The Low Income Program is raised here to illustrate the lack of evenhandedness with which Staff assesses the credit card matter.

more than tripling by the third year to $1,213,000 (CHGEIB App. B).

Staff points to the expectation that in the third year only roughly one-quarter of customers are expected to pay by credit card (SIB 37). This equates to approximately 89,000 customers (Ex. 4). The Low Income Program would apply to 1,000 customers (Ex. 3, Sch. B). The third year costs, therefore, are $16 for each credit card user and $1,213 for each Low Income Program participant. Staff claims that the benefits of the credit card program are not worth the costs. Both programs, however, are primarily predicated on the value of intangible benefits to customers.

Staff complains that the Company has not investigated the possibility that offering the credit card payment option will reduce uncollectibles and has, therefore, "failed" to explore savings that might offset some of the costs (SIB 38). Staff does not point to the same "failure" associated with the Low Income Program.

Staff points to the costs of the credit card proposal falling on the general body of ratepayers and complains of non-credit card users subsidizing credit card users (SIB 37). So too would the costs of the Low Income Program fall on the general body of ratepayers.

The Company's proposal is not novel for New York utilities and is a means by which it can keep in step with customer interests and expectations as have other entities which traditionally did not, but now do, accept payment by credit card (CHGEIB 60-61). A balanced assessment of the Company's proposal within the overall context of this proceeding calls for its approval.

IV. CAPITAL STRUCTURE, FINANCIAL INTEGRITY AND RATE OF RETURN ON COMMON EQUITY

A. Financial Integrity and Equity Ratio

The Company will substantially rely on its initial brief, but asks that the Presiding Administrative Law Judge also consider the following.

Staff knows that the equity ratio will decline from the initially established value, but Staff criticizes Central Hudson for *seeking* an initial 49% equity capitalization ratio, and Staff inconsistently seeks to *impose* a more risky 47% ratio without recognizing either the increased risks of Staff's proposed starting point or the increment in increased risk as the ratio inevitably declines.

Furthermore, while Staff has pointed to a number of operating risks, it has done nothing to demonstrate a reduction in overall risk. At a time when large, formerly financially sound utilities face bankruptcy due to bungled implementation of retail access, Staff casually dismisses the risks of distributors. Staff relies upon backward looking criteria of rating agencies without consideration of the prospect for adjustment of the criteria in response to a real present day problem and Staff demands that the Commission adopt a policy of supporting no more than the minimum. This is a short sighted and poor policy proposal that should not be recommended to, or adopted by, the Commission.

B. Rate of Return on Common Equity

The Company's evidence in this proceeding supports a return on equity of 11.5 percent (CHGEIB 26-30). The Staff and CPB return on equity recommendations, 10.3 and 10.2 percent, respectively, have been shown to be substantially understated (CHGEIB 31-34). In their initial briefs, Staff, CPB and MI criticized the evidence supporting the Company's 11.5 percent recommendation, while claiming to buttress support for a return on equity allowance of no more than 10.3 percent. Below, the criticisms of the Company's analysis made by Staff, CPB and MI are shown to be either factually incorrect[30] or unsupported in

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[30] Staff does not even describe the Company's position correctly in many instances. For example, it claims that Company is requesting a return of 12.0 percent (SIB 43), when, in fact, the Company is requesting a return on equity of 11.5 percent (Tr. 849).

the record.[31] Their efforts to give credibility to a cost of equity recommendation in the 10.2-10.3 percent range are also unavailing, as shown below.

1. Changes in Interest Rates

CPB makes much of a decline in the yield on 30-year Treasury bonds over the last five years (CPBIB 8). MI echoes this sentiment in its brief (MIIB 58). Their reference to these data is inapposite for several reasons. First, the Commission has regarded changes in bond yields as an imperfect measure of changes in the cost of equity for even short periods.[32] To assume other things being equal over a period as long as five years is simply not reasonable, especially given all the changes in the electric utility industry over this period. Second, 30-year Treasury bonds are a biased measure of changes in the cost of money, in general, over the past several years. It is public knowledge that the Treasury Department has announced that it will be issuing fewer long-term Treasury bonds in the near future and there is speculation that such long-term bonds will no longer be issued at all. Because of these circumstances, many financial

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[31] CPB argues that if the Company witness had performed a calculation in the manner that the CPB witness is recommending, the Company result would be similar to that of the CPB (CPBIB 12). This is merely an internally circular tautology, not evidence.

[32] When the Commission has examined changes in bond yields, it has only employed one-half the change in such bond yields for cost of equity updating purposes.

institutions which have a need to lock in long-term rates have been rushing to buy such bonds—artificially driving their prices up, and their yields down.[33] Thus, 30-year Treasury bonds are a biased indicator of the change in the cost of money.

2. Tests of Reasonableness

The Staff (10.3%) and CPB (10.2%) return on equity recommendations are well below returns allowed on equity for electric utilities in general over the past year and are about 150 points below allowed returns in the latest quarter[34] (Tr. 851). CPB criticizes use of these returns as a test of reasonableness, claiming that there was no showing that these were returns allowed for companies of similar risk to Central Hudson (CPBIB 12-13). Company witness Rosenberg employed the recent allowed returns on equity as a rough indicator of the cost of

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[33] In fact, *The Wall Street Journal* of May 3, 2000, in announcing that that newspaper would no longer use 30-year Treasury bonds as a benchmark stated that: "...trading in the 30-year bond in recent months has started to reflect this charged supply-and-demand dynamic, rather than usual fundamental concerns of bonds...."

[34] Using an RRA publication dated October 10, 2000, Mr. Rosenberg examined returns allowed over the year ending the third quarter of 2000 and also the returns allowed for the third quarter 2000 by itself. MI seizes upon a typographical error in Mr. Rosenberg's testimony at Tr. 851, line 10) claiming that the most recent quarter's return examined by Mr. Rosenberg was more than a year distant and hence irrelevant. However, as clearly indicated in Footnote 3 at Tr. 851, the latest allowed returns available which were referenced in Mr. Rosenberg's testimony were for the third quarter of 2000 and thus very relevant for consideration in this proceeding.

equity for utilities, in general, at the current time. His point is that the return recommendations made by Staff and CPB are so far away from the return levels being granted to other utilities as to bring into question the credibility of the Staff and CPB estimates. Recall that Value Line has specifically commented twice in the past few months that Central Hudson's allowed return on equity was low, while Fitch indicated that it would be closely observing the ROE that comes out of this proceeding (CHGEIB 31-32). Thus, such a comparison with the allowed returns of other utilities is relevant. CPB has claimed that the Company has not established the risk comparability of the companies whose allowed returns were reported by Mr. Rosenberg. However, the average utility has a bond rating of A and the spread between A and Baa utility bond yields is currently about 20 basis points. Thus, any plausible differences in risk cannot account for the recommended returns of Staff and CPB being fully 150 basis points below the recent average allowed return on equity.

3. Appropriateness of Proxy Groups

Company witness Rosenberg selected his proxy group on the basis of having an A bond rating, no merger activity and no significant unregulated operations. CPB criticized Mr. Rosenberg's sample as being too small (CPBIB 9-10), while Staff criticized some of the companies in Mr. Rosenberg's proxy group as having unregulated operations (SIB 44-45). Both criticisms are incorrect and, in fact, illustrate glaring weaknesses in the proxy groups of both CPB and Staff. Mr. Rosenberg started with a group of A-rated companies, but then deleted companies undergoing mergers and companies with significant unregulated operations. Staff and CPB, in sharp contrast, simply used all A-rated companies, no matter how their cost of equity calculations would be distorted by ongoing mergers and unregulated operations. Mr. Rosenberg's proxy group is much more comparable in risk to Central Hudson than are the large, amorphous groups of Staff and CPB. Both Staff and CPB have included numerous companies in their samples that are currently undergoing mergers – companies whose stock prices move significantly based on near-term factors reflecting the likelihood of merger consummation. However, to properly perform cost of equity calculations, stock prices should instead reflect the long-term risk and growth prospects of the company.[35] In fact, Mr. Rosenberg pointed out (Tr. 856-857) that Mr. Niazi thought the DCF was unreliable because it was distorted by companies undergoing mergers. Although CPB claims that "market conditions have changed,"(CPBIB 14-15) there are still many companies in both the proxy groups of Staff and CPB that are currently undergoing mergers at the current time, thus likely

[35] For example, Empire District Electric – a company in Staff's proxy group – had its price drop 17 percent in less than a month. Value Line attributed this decline to investor pessimism concerning the prospects of a merger (*The Value Line Investment Survey*, January 5, 2001, p. 710).

distorting any cost of equity calculations performed on such companies.

Staff criticizes Mr. Rosenberg's proxy group claiming that two of the companies in the group were heavily involved in unregulated activities (SIB 45). Apparently Staff believes in the philosophy of "do as I say, not as I do," because Staff, itself, uses those two companies as part of its proxy group.

4. DCF Analysis

CPB (incorrectly) faults Mr. Rosenberg's DCF analysis for (supposedly) not employing Value Line projections for near- or long-term growth (CPBIB 10).[36] However, Mr. Rosenberg did employ Value Line projections for both his near- and long-term growth rates. For the near-term growth rate, Mr. Rosenberg used both Value Line and IBES growth projections. In fact, as can be derived from data shown on Ex. 91, Sch. 2, the average of the Value Line short-term growth rates is 7.4 percent, while the average of the IBES short-term growth rates is 5.5 percent. Thus, had Mr. Rosenberg not included the IBES data, his DCF result would have been even higher than the result he reported in his testimony. Similarly, for the long-term growth rate in the DCF analysis, Mr. Rosenberg used one calculation employing the projected long-run growth in GDP and a second calculation

[36] MI makes a similar criticism (MIIB 53) which is also incorrect.

employing the Value Line long-term projected retention growth (Ex. 91, Sch. 2). Once again, Mr. Rosenberg obtained a higher DCF result using the Value Line data, so if one were to accept the criticisms of CPB and MI and exclude the GDP growth rate calculation, Mr. Rosenberg's DCF cost of equity calculation would have been higher than reported in his testimony. The use of a variety of growth projections in this time of great uncertainty for utilities is a better approach than relying merely on one source. However, as discussed above, if Mr. Rosenberg's calculations were adjusted to use only Value Line data, he would have obtained a higher DCF cost of equity estimate than the one reported in his testimony.

5. <u>CAPM Analysis</u>

In the CAPM approach, the parties do not differ much on the beta and risk-free rate to be employed in the calculation. Mr. Rosenberg employed a beta of 0.55 and a risk-free rate of 5.95 percent (Tr. 842-843). The parties do, however, differ greatly about the appropriate expected market risk premium to employ in the CAPM approach. Mr. Rosenberg employed two estimates, an historic average risk premium based upon Ibbotson data and an expectational calculation based upon a DCF analysis for the S&P 500 Composite (Tr. 843-844). Both Staff and CPB, in contrast, employed an expected market risk premium based upon a Merrill Lynch projection for the expected return on the market.

While Staff seems to take pride that its CAPM result is far below the CAPM result calculated by Central Hudson (SIB 43), the fact that it is so far lower than the Company result is just another sign of the Staff CAPM's <u>un</u>reasonableness.[37] Both Staff (SIB 44) and MI (MIIB 53) try to support the use of the Merrill Lynch projected return in this proceeding because the Commission in a proceeding five years ago found the use of Merrill Lynch was a reasonable method. However, based on the evidence in this record, the use of Merrill Lynch is patently <u>un</u>reasonable. Staff witness Summers' CAPM result of 8.62 percent (Ex. 97) is only 29 basis points above the 8.33 percent average yield on A-rated debt during his pricing period (Tr. 855).[38] Mr. Rosenberg provided numerous other reasons which indicated that the use of the Merrill Lynch estimate was <u>un</u>reasonable at the current time in a CAPM calculation (Tr. 854-856).

While the parties criticize the use of the Ibbotson risk premium, this approach was adopted in the Consensus Document in the Generic Financing Case and was used by the Judges in their calculations for the Recommended Decision in that proceeding.

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[37] Staff claims that its witness' CAPM estimate is 8.87 percent (SIB 43). That is incorrect—the CAPM cost of equity estimate of the Staff witness is, in fact, only 8.62 percent (Ex. 97).

[38] Mr. Summers originally reported a CAPM result of 8.87 percent, but then corrected it in Ex. 97 to a figure of 8.62 percent.

The Judges also indicated in that decision (Case 91-M-0509, at 53) that:

> ...it would be possible to perform a CAPM computation using a current assessment of the market's required return at any particular time....

That is exactly what Mr. Rosenberg did for his second approach. Thus, when Staff claims (SIB 44) that Mr. Rosenberg's second estimate of the market risk premium, using the S&P 500 Index, does not accord with the CAPM methodology recommended in the Generic Financing Case, it is simply incorrect.

While the use of the Merrill Lynch projection in this proceeding is demonstrably unreasonable, the Company's two estimates of the expected market risk premium are both reasonable and well-supported inputs for the CAPM calculation.

6. Risk Premium and Comparable Earnings

The parties claim that the Commission has not used the risk premium and comparable earnings methods in the past. However, given the turmoil facing electric utilities currently relating to deregulation, the uncertain path of competitive developments, mergers, etc., there is clearly likely to be more error of estimation in the methods traditionally used by the Commission. The use of the risk premium and comparable earnings methods helps bring an alternate perspective to the estimation of the cost of equity in these turbulent times for utilities.

7. Conclusion

The 10.2-10.3 percent recommendations of CPB/Staff have been shown to be clearly understated. In contrast, the arguments criticizing the Company's 11.5 percent ROE recommendation have been refuted in the discussion above. The Commission should allow the Company an 11.5 percent return on common equity in this proceeding.

V. COMPANY-WIDE COST, EXPENSE AND RATE BASE ISSUES

A. Employee Level and Labor Expense

Staff's initial brief contains several erroneous characterizations of the record, conclusory statements and irrelevancies in its effort to supplant the Company's detailed and need-based employee level projection of 900 with a level of 869 which results from Staff's mechanistic attrition trend line approach. Staff, whose witness stated that no needs assessment had been done (Tr. 1190), asserts on brief aggressively, but without any record basis, that its staffing level is "sufficient"(SIB 30).

The Company's initial filing reflected labor expense based on 922 employees representing its actual employee level at December 31, 1999 excluding employees associated with its then extant fossil production operations (Tr. 542). The Company indicated that it would be appropriate to update the employee level later in the proceeding in order to better recognize the potential effect of the then contemplated divestiture of its fossil production facilities (Tr. 542). The non-production employee level of 922 was, therefore, intended to be a "place-holder" (Tr. 542). In its rebuttal filing of December 28, 2000, shortly before the closing of the sale of Danskammer and Roseton, the Company presented the update to its actual non-production employee level. Such employee level was 904 as of December 21, 2000 (Tr. 554). Along with this update to current data, the Company also presented projected employee levels in detail for years 2001-2004 for each of the non-production departments or areas of the Company which, for periods corresponding to the rate year, aggregate to 898 employees (Ex. 63). That projection is the result of a needs assessment for each of the Company's individual areas or departments (Ex. 64).

Because, at the time of the update, the then-current actual level of 904 non-production employees approximated the detailed projection of 898 non-production employees and both approximated the level of 900 non-production employees at which further attrition is not likely to be absorbed, the Company recommended that the labor expense rate allowance be based on 900 non-production employees (Tr. 554-555, 557-558).

On brief, Staff belatedly attempts to portray its attrition trend result as a response to inadequacies in the Company's detailed employee level analysis (SIB 29-30). It was not. In its initial filing, Staff stated its intent to ignore the Company's planned updated presentation sight unseen (Tr. 1179) and presented its attrition trend results in response to the Company's "placeholder" employee level.

Staff also attempts to portray its proposed adjustment as one which would "properly" account for the employee level effects of the sale of the Company's fossil generation plants (SIB 29). There is no credit to be garnered on this basis. And while Staff's attrition trend line approach and the Company's detailed projection are based on entirely different approaches, both accounted for fossil production employees in the same way - their historical effects on the Company's employee level were excluded and no such employees are included in the rate year employee levels.[39]

Staff attempts to discredit the Company's recommended non-production employee level of 900 by claiming it resulted from the simple subtraction of production employees from the total number of employees (SIB 31). The extensive details of the employee level projection in Exhibit 63 and the needs assessment by area or department within the Company on which it is based (Ex. 64) belie that assertion. Furthermore, it is just this kind of needs assessment that is so sorely lacking in Staff's

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[39] As a result, CPB's concurrence with Staff's adjustment on the basis that it results from the Company's divestiture of its fossil generating plants (CPBIB 4-5) is meaningless.

mechanistic "deflator" approach to arbitrarily reducing the labor allowance.

Staff objects to reliance on the Company's need based detailed projection set forth in Exhibit 63 by claiming that its inclusion of production employees "distort[s] the overall result" (SIB 32). Company witness Brocks explained the very practical business reasons for production employees being included in the study which became Exhibit 63. Not knowing at the time the study was prepared when the closing of fossil generation sale would occur, those employees were left in but presented in a way that quite clearly separated them from non-production employees so that there would be no distortion of the nature Staff attempts to invent (Tr. 556-557). Staff's objection is a baseless red herring.

Recognizing apparently the lack of merit to its criticism of the Company's needs assessment, Staff also objects to reliance on Exhibit 63 because of the "telling absence of any other study" (SIB 31-32). Staff is correct that Exhibit 63 is the only study that supports an employee level projection in this proceeding. Staff performed no "study" at all to show that its trend line employee level of 869 is adequate to meet the Company's needs (Tr. 1190). The Company presented the study contained in Exhibit 63.

Staff attempts to avoid its own admitted lack of a needs assessment by the bizarre assertion that "[t]he utility's budget for that number of employees is not sufficient proof that the number of personnel it would like to employ is warranted by its needs" (SIB 32). Staff must think that the Company should prepare its own plan for its future operations (i.e., its budget) and then also prepare some sort of independent plan for its future operations (i.e., another budget). But if the first is inadequate for Staff (although in fact representing the Company's plan), why would Staff find a second to be better? And why are two necessary if Staff has not been able to identify any legitimate flaw in the already existing budget? Staff thus assumes the astounding posture that a Staff proposal need not be supported by any study at all while a Company proposal cannot stand without two, or perhaps more, supporting studies.

Staff attempts to justify its attrition trend line approach to determining the Company's staffing level needs by pointing out that it is based on actual data and that the trend line was extended only to the mid-point of the rate year (SIB 31). This is nothing more than a description of the mechanics Staff employed, which leaves unanswered the important question of why or how those mechanics produce an employee level that bears any, much less a proper, relationship to the Company's needs. Staff's assertion that reliance on its trend line is "clearly reasonable" (SIB 31) is supported by and lends support to nothing.

Staff continues with its reference to the Company's common administrative and general expenses (SIB 30). Staff raised the issue of common expenses with respect to the imputation of a productivity adjustment to be applied in addition to and irrespective of its adjustment related to setting the employee level at 869 (Tr. 1181). Staff now flips the evidentiary record. On brief Staff attempts to argue that the basis for its productivity adjustment, which it initially claimed was separate from and should not be undermined by its employee level reduction, was actually a reason for its employee level adjustment. It was not and Staff's desperate briefing point should, therefore, be rejected.

Staff raises the expense analysis that it presented, purportedly in support of its employee level recommendation (SIB 30). In addition to continuing the mystery of any way in which Staff's expense analysis has any bearing on the issue (Tr. 552-553), Staff resorts to misrepresenting the Company's rebuttal testimony addressing that expense analysis and, in doing so, slips in a change in its position as to the purpose of the analysis.

Staff presented a comparison of the percentage reduction in the Company's employee level and the percentage increase in

O&M expenses other than labor, fringe benefits and those related to electric production and somehow concluded that because the percentage reduction in employees was greater than the percentage increase in expenses and because the increase in expenses was low, its recommended employee level of 869 is justified (Tr. 1180-1181; SIB 30). The Company's rebuttal testimony and brief pointed out that Staff's attempt to support its employee level recommendation with this data was illogical and, in the event there did happen to be any logic that escaped the Company, Staff's analysis itself was flawed because Staff's cursory review failed to reveal that the low overall increase in expenses was significantly affected by large decreases in certain expenses such as property insurance that definitely have no relationship to the level of employees (Tr. 552-553; CHGEIB 63-64).

On brief, Staff mis-describes this testimony as a "complain[t]" by the Company that its expenses are increasing more rapidly than Staff assumes (SIB 31) thereby creating the illusion that the Company acknowledged that Staff's reliance on the expense analysis has logical merit. Staff, however, then implicitly recognizes the legitimacy of the Company's observation that Staff's expense analysis was insufficiently rigorous. Staff does so by abandoning its testimonial position that its employee level recommendation is justified by low expense growth, by claiming that Staff's point is the same even if the opposite is true (SIB 31). Staff has, therefore, made clear that its claim that its recommended employee level of 869 was supported by its expense analysis had no merit from the outset.

Staff has offered no meaningful support for its mechanistic trend line application result of 869 employees - it should be rejected. The Company's recommended employee level of 900 is supported by a need based assessment by operating area or department and it has not been subject to any meaningful challenge - it should be adopted.

VI. ELECTRIC COST, EXPENSE AND RATE BASE ISSUES

A. Right of Way Maintenance Expense

Staff's initial brief contains several mis-descriptions of the record, constitutes an abandonment of its testimonial position and sets forth information demonstrating that its position that a portion of the Company's right of way maintenance (tree trimming) expenses should be disallowed is unsupportable.[40] MI's initial brief on the subject also encourages the disallowance but it fails to recognize record evidence that

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[40] On the issue of Central Hudson and Verizon's contractual relationship, it should also be noted that Staff (SIB 15-16) improperly characterizes Verizon's agreement to pay a portion of the trimming costs for 1988 under the 1988 letter agreement (Ex. 11, Sheet 2) executed under the 1986 Joint Use of Poles Agreement as obligating it to do so in subsequent years. (Staff refers to a 19<u>9</u>8 agreement in advancing this incorrect point. That reference appears to be a typographical error and the intent appears to be to refer to the 19<u>8</u>8 letter agreement included in Ex. 11.)

nullifies the basis of its position.[41]

Staff acknowledges that the Company's contract with Verizon calls for a sharing of tree trimming costs in relation to each party's needs for trimming (SIB 15). As pointed out by the Company (CHGEIB 76), Staff's witness did not, nor was he competent to, perform any assessment of whether Verizon's position that it has no need for the trimming has or lacks validity (CHGEIB 76).

Staff's brief, however, materially mis-describes the record to create the illusion that Company testimony addressing technical differences between electric and telephone facilities was inadequate to support the conclusion that the differences are relevant to determining the relative needs of the Company and Verizon. There was no such testimony. Staff refers (SIB 17) to its own testimony (Tr. 1205-1207) under cross-examination by MI during which Staff concedes that its disallowance is in no way based on any consideration of the respective telephone and electric facilities. Staff then characterizes that testimony as proof that any consideration of those differences is "unpersuasive" (SIB 17). Staff's implicit acknowledgment on brief, together with its witness' explicit acknowledgment on cross-examination, that it has not properly addressed the relative

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[41] MI premises its recommendation for a disallowance not on any contractual basis (MIIB 91) but, rather, on its conclusion that the Company has done absolutely nothing to obtain contributions (MIIB 89, 90, 91). There is no basis for this position and the record contains evidence that it is incorrect (Ex. 120).

needs of the Company and Verizon for the tree trimming that the Company performs highlights a crucial omission in Staff's presentation.

During discovery, the Company asked Staff whether Staff had taken any action against Verizon. Staff's response essentially sought to deflect the inquiry and the matter was pursued at the hearings (Ex. 121, Tr. 1198-1199). In this context, the Company acknowledges Staff's recognition on brief that a proximate cause of Verizon's change in position and refusal to agree that it had a "need" for sharing the line clearance costs with Central Hudson was a rate plan, presumably reached with the agreement of Staff and later approved by the Commission. Staff's statement on brief indicates that, in attributing the entire problem to Central Hudson's alleged lack of action, Staff's adjustment is overstated. As shown above and in the Company's initial brief, Staff's adjustment is also without foundation.

B. <u>Storm Expense and Storm Reserve</u>

1. <u>Storm Expense Rate Allowance</u>

Staff states (SIB 19, n.9) that the Company "requests that it be allowed" to update the storm expense rate allowance to reflect the data from the year 2000. As explained by the Company (CHGEIB 77-78), doing so would be consistent with the method used by the Commission in numerous Company rate cases of basing the rate allowance for this highly variable expense on the average of such expenses during the most recent four calendar years. Staff's concurrence with the Company's methodology, including the updating process applicable to this and many other expense items at the time of Briefs on Exceptions (Tr. 1220-1221), however, is not mentioned in Staff's initial brief.

Rather than acknowledging its concurrence with continuing the method and updating process described above, Staff signals what appears to be an intent to perhaps not follow through. Staff complains that it did not have an opportunity to review the storm expense update data earlier (SIB 19, n.9). Staff, however, provides no explanation of why this concern exists with respect to updating storm expenses as opposed to any of the many other update items at the time of Briefs on Exceptions in accordance with past practice which it has again agreed to here.

If Staff has gotten cold feet because of concern that the update might produce an increase in the four-year average, that would not justify not following through with the established practice. The four-year average method was established, and has been maintained, to provide a rate allowance that smooths over time these expenses that have a tendency to be highly variable on a year to year basis. Staff has not offered any objective basis to suggest that continuation of that practice with updating at the routine and agreed to time should not be followed in this case.

2. Reserve for Major Storms

Staff argues that the Company's proposed rate allowance for storm expense "is already excessive" and, therefore, there is no need to create the reserve for major storms proposed by the Company (SIB 19). To cure the "excessive" storm expense rate allowance Staff recommends that it be reduced to reflect potential savings due to the Company's implementation of an Outage Management System (SIB 19). Adoption of Staff's recommendation, to which the Company does not object (CHGEIB 79), therefore, moots Staff's argument that the unadjusted level of the storm rate allowance should preclude establishing the storm reserve.[42]

Staff incorrectly characterizes the Company's reasoning for establishing a rate allowance to fund a reserve against the costs of major storms. Staff insists that the Company is motivated by unfounded concern that it will be denied recovery of storm costs if it must rely on the deferral of those costs (SIB 20). This is not the case.

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[42] Staff's argument (SIB 21) that the funding requested by the Company to establish a reserve for the costs of storms that would qualify for deferral accounting is somehow included in the rate allowance for storms which is based on the cost of storms that did not qualify for deferral accounting is cut from whole cloth.

As the Company has explained (Tr. 1618; CHGEIB 79-80), the Company's reasoning for the reserve is that it will serve to mitigate the rate impact of recovering costs that have been deferred. Consequently, the subjective concerns attributed to the Company in Staff's brief have nothing to do with the matter at hand, because the funds in the reserve would apply only to costs that have been approved for deferral. It does not affect the deferral process in any way.

CPB argues (CPBIB 18) that rather than establishing a storm reserve, "such funds" would be better employed to reduce delivery rates or expand retail access. It is not clear, however, whether CPB has missed the point that absent approving the Company's request for a rate allowance there simply are no "such funds" or is suggesting that the requested $500,000 rate allowance be approved but that the funds be directed to purposes other than funding a reserve for deferred storm costs.

Stating that it is referring to a storm reserve issue that "remains" (SIB 21), Staff raises a new issue. In November, 1999, Central Hudson requested Commission approval to net storm costs resulting from the September, 1999 Tropical Storm Floyd against 1999 "excess earnings" under the Restructuring Settlement Agreement. In April, 2000, the Commission approved the

Company's request.[43] The Commission noted that under the Central Hudson Restructuring Settlement Agreement, the requested offset had the same effect as expensing the costs currently.

Staff states that since April 2000, the Company has continued to accrue a storm reserve without Commission approval. Staff's initial brief claims, for the first time, that the current balance in the deferred account ($625,000) should be "added" to the current balance in the "excess earnings benefit pool of $7.8 million" (SIB 21); effectively increasing the balance to $8.4 million.

Staff asserts that the reserve was "established at Central Hudson's risk without Commission authorization." In fact, the Commission's April Order acknowledged the existence of the Company's storm reserve accounting and the fact that it had been established "with concurrence from [Central Hudson's] external auditors...." (April Order 3). Moreover, the April Order, with Staff's approval and recommendation, utilized the balance in the deferred account and thereby ratified its establishment. It is also important to note that Staff's recommended use of the storm reserve, which was approved by the Commission, produced precisely the result that would be obtained under the Company's storm reserve accounting proposals in this

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43 Case 99-E-1600, Central Hudson Gas & Electric Corporation - Tropical Storm Floyd Cost Deferral, Untitled Order (issued April 28, 2000) ("April Order").

proceeding. There is no basis for the assertion in Staff's brief that the continuation of this deferral is "at Central Hudson's risk" or for any implicit criticism of Central Hudson for continuing the accounting practice utilized by Staff in its recommendations and relied upon by the Commission in the April Order.

Furthermore, Staff is several months premature in its current quest for the balance in the deferred account. The appropriate time for dealing with the current deferred balance is in the final reconciliation process already provided for in the Restructuring Settlement Agreement as of June 30, 2001. Finally, given Central Hudson's pending request for the "excess earnings" funds already deferred under the Restructuring Settlement Agreement, the Company's prior request to reduce that amount by roughly half further underscores just how modest Central Hudson's request truly is.

VII. <u>ELECTRIC COST OF SERVICE AND RATE DESIGN: MANDATORY TOU RATE</u>

Staff mis-interprets PSL § 66(27) in its initial brief (SIB 56), contending that such section requires Central Hudson to maintain an electric TOU rate classification. However, Staff neglected to consider the fact that Central Hudson's electric revenues will, not after the effective date of the new rates, meet the $200 million threshold criterion of the statute.

Therefore, Staff's position is incorrect and Central Hudson's proposal should be approved.

VIII. GAS ISSUES

A. Gas Sales Forecast

Staff seeks to impose a rule-based approach to the gas sales forecast through arguing that other utilities use the 30 year average degree day information and, therefore, that approach should be imposed on Central Hudson. Staff's position is unreasonable. Staff avoids recognizing Company witness Buck's unchallenged testimony about an analysis she performed that demonstrated that Staff's 30 year data series is, in fact, less accurate than Central Hudson's ten year series by pointing out that Central Hudson did not offer its study for the record. While true, the fact is irrelevant because the study was described in testimony that is in the record and Staff is in possession of the study, it having been provided in response to Staff Interrogatory 114. If Staff had a basis for questioning the study, it would have brought it forward at the hearing rather than quibble afterwards about a matter that it had the opportunity of addressing and apparently did address because it asked for and received the study.

Contrary to Staff's baseless attempt to discredit Central Hudson's motives on brief through claiming Central Hudson was selecting the option that "most benefits" itself, in fact, as Ms. Buck stated, Central Hudson is supporting the choice that is most accurate. Utilizing most accurate data does not "benefit" Central Hudson in any inappropriate way, and it is obviously better to set rates based on more accurate data, rather than the less accurate data Staff advocates. Furthermore, Staff has not presented any basis for believing that there is any error in Ms. Buck's testimony. Staff's generically wrong approach to degree days should be rejected and Central Hudson's specifically correct approach approved.

B. Potential Gas Sales to Dynegy

MI contends that a potential gas contract between Central Hudson and Dynegy should be "recognized" in this case. But there is no contract yet and there is no present basis on which to forecast revenues if and when a contract is entered into.

C. Interruptible Sales Imputation

Staff urges the continuation and increase (from $1.9 million to $2.3 million) of a base rate imputation of profits from the Company's interruptible services. Under this approach, the Company can avoid a financial loss only if it actually receives more than the imputed level and can only receive financial benefits for what Staff describes as "excellent performance" (SIB 26-27).

The Company has explained (CHGEIB 93-99) several reasons why use of an imputation incentive mechanism for interruptible profits should be discontinued given its transformation into a delivery service company. These include the risk an imputation places on a delivery service provider related to the "uncertainty" of the level of gas that interruptible customers will use. The level of usage is dependent upon the relative market prices of gas and the customer's alternate fuel. The market price of gas has risen to such high levels that the Commission has been forced to take emergency action to adjust interruptible pricing mechanisms that were rendered inoperative. Even with those adjustments, the market price of gas seriously impairs the Company's ability to make interruptible sales (Tr. 459). Staff's proposed continuation of the imputation mechanism (much less Staff's proposed increase in the amount) gave no consideration to the economic conditions that required the Commission's action. Continued imputation is not appropriate in these circumstances because the economic realities of the market place can prevent the Company, regardless of its efforts, from making such sales during present market price conditions and during the soon to begin rate year.

Staff's refusal to reconsider its proposed interruptible imputation position is also undercut by its position on the treatment of profits from sales of gas used in electric generation. The incentive structure that Staff recommends for profits from these sales does not employ a base rate imputation. Staff has stated that an imputation here "is not proper" (SIB 27) because of "the uncertainty involved in projecting" (Tr. 1019) the profits from these sales. Because of this uncertainty as to the level of expected profits, Staff recommends that a threshold profit level rather than an imputation be used to mark the point at which shareholders would share in the profits because of the Company's "excellent performance" (SIB 27-28). Given that the same problems exist in relation to establishment or attainment of an interruptible sales level, a similar threshold profit level for sharing approach should also be applied to the interruptible sales in lieu of a rate base imputation.

IX. COMPLIANCE PHASE

Staff refers several times on brief to a compliance phase, but does not appear ready to engage the topics to which it refers. Inasmuch as the mechanical implementation topics Staff apparently wishes to discuss will require a period of weeks to implement (e.g., programming and other IS requirements), Central Hudson invites Staff to identify its proposals at its earliest opportunity.

X. CONCLUSION

Central Hudson respectfully requests that its recommendations be adopted for the reasons presented in its testimony and exhibits and its briefs.

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New York, New York

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day caused to be served the foregoing "Reply Brief on Behalf of Central Hudson Gas & Electric Corporation" upon all active parties of record in this proceeding in accordance with the requirements of the Rules of Procedure.

Dated at New York, New York, this 28th day of February, 2001.

Robert J. Glasser