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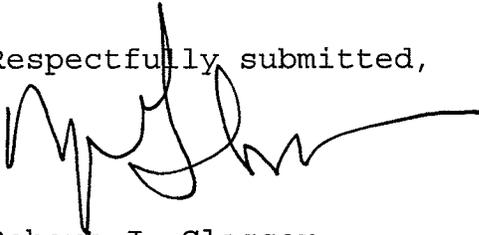
Hon. Jaclyn Brilling  
Secretary  
New York State Public Service Commission  
Three Empire State Plaza  
Albany, New York 12223

Re: Case 06-M-1017 - Proceeding on Motion of the Commission as to the Policies, Practices and Procedures For Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers

Dear Secretary Brilling:

Enclosed please find an original and twenty-five copies of the Phase II Initial Comments on Behalf of Central Hudson Gas & Electric Corporation for filing in the above-referenced proceeding. Copies of this document will be served electronically, and by first class mail, on the Active Parties List in this proceeding on June 5, 2007.

Respectfully submitted,



Robert J. Glasser

Enclosures

PUBLIC SERVICE COMMISSION  
OF THE STATE OF NEW YORK

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: Proceeding on Motion of the :  
: Commission as to the Policies, :  
: Practices and Procedures For :  
: Utility Commodity Supply Service to :  
: Residential and Small Commercial and :  
: Industrial Customers. :  
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Case 06-M-1017

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PHASE II INITIAL COMMENTS ON BEHALF OF  
CENTRAL HUDSON GAS & ELECTRIC CORPORATION

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PHASE II INITIAL COMMENTS ON BEHALF OF  
CENTRAL HUDSON GAS & ELECTRIC CORPORATION

PRELIMINARY STATEMENT

The original purpose of this proceeding was to investigate electric and gas utility supply portfolio management practices, particularly in relation to bill "volatility."<sup>1</sup> The Order Initiating Proceeding listed seven questions for public comment in relation to "volatility."

Some parties' initial comments, in addition to addressing the Commission's questions, suggested that the case be expanded to include consideration of future sources of electric generation, and whether long-term contracts might properly play a role in facilitating new electric generating plant construction. Among other things, it was said that the State has a significant imbalance between loads and electric generating resources; that long-term contracts may facilitate financing of new electric generating plants; and that

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<sup>1</sup> Case 06-M-1017, Order Instituting Proceeding (Issued and Effective August 28, 2006).

"integrated resource management" should be used to determine how to meet future power needs.

In December 2006, Central Hudson responded to those statements in its Phase I reply comments. Among other things, Central Hudson agreed that the present proceeding should include consideration of "resource adequacy." Considering load forecasts based on historical trends, Central Hudson has been concerned that, over a twenty year planning horizon, there is an obvious need, driven by power requirements in the metropolitan NYC area, for about 2500MW of new, fuel-diversified generation. Reliability, environmental impact (and equity) considerations suggest that new generation should be built in, or as close as possible to, the NYC metropolitan load center. Central Hudson was also concerned with fuel diversity and security. Over the last ten-year period, the only type of new generation built by "lightly regulated" generating companies (apart from RPS-supported renewables) has been gas-fired, combined-cycle generation.<sup>2</sup> This trend is producing a high energy-cost supply portfolio and more volatile energy prices as a result of the increased use of natural gas as the marginal fuel and the NYISO's LBMP market design, together with long-term increasing price trends and short term price fluctuations of natural gas.

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<sup>2</sup> Since deregulation of the electric utility industry in the State, some 5500MW of new gas-fired combined-cycle electric generating capability has been built.

On April 19, 2007, the Commission established Phase II of this proceeding.<sup>3</sup> Consistent with the interest in clean power generation and increased energy efficiency/demand side alternatives expressed in the Spitzer Administration's "15x15" Policy, in Phase II the Commission is considering whether to develop a statewide Integrated Resource Plan ("IRP") to address "public policy" considerations not presently being reflected in the development of new generation, and to respond to what may be "a growing need for a rational and comprehensive decision-making approach to guide the future of New York's electricity infrastructure." In addition, the Commission seeks to evaluate "the use of long term contracts [to] facilitate entry of new supply."<sup>4</sup> In a related proceeding, the Commission is considering increased levels of energy efficiency.<sup>5</sup>

#### Summary Of Central Hudson's Position

Central Hudson welcomes Phase II, because of the importance of assuring both resource adequacy and other legitimate public policy goals. Central Hudson supports establishment of a

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<sup>3</sup> Case 06-M-1017, Order Requiring Development Of Utility-Specific Guidelines For Electric Commodity Supply Portfolios And Instituting A Phase II To Address Longer-Term Issues (Issued and Effective April 19, 2007).

<sup>4</sup> Given the Commission's stated purpose of considering long-term contracts in relation to new supply, Central Hudson understands that this proceeding is limited to consideration of long-term contracts in relation to new facilities only. Long term contracts were defined as those of five years or longer duration. Five years may be representative of the period of time required to finance and develop a gas-fired combined cycle plant, but it is too short to allow for the financing and development of other types of central station plant. In addition, in the RPS Program, developers have generally sought contracts of fifteen years or longer duration.

<sup>5</sup> Case 07-M-0548, Order Instituting Proceeding (Issued and Effective May 16, 2007) ("Efficiency Case").

statewide IRP.<sup>6</sup> Central Hudson also supports examination of the role of long-term contracts to support lightly regulated generating company construction of new plants, provided that examination takes place together with simultaneous examination of the role of equivalent long-term rate-relief commitments to regulated utilities to support utility construction of supply-side resources as an alternative to long-term contracts.

The proposal of a statewide IRP and the 15x15 policy are acknowledgements that the experience of the past decade has not been satisfactory, and that the challenges for the future are significant.

Generating companies' perceived forward price curves have been sufficient to produce only a limited, lumpy addition of gas-fired combined cycle plants; the lowest capital cost, shortest-construction-time type of base load facility.<sup>7</sup> As a result of forecast load growth and the absence of committed new capacity, the NYISO found, in the Reliability Needs Assessment ("RNA") Report it issued on March 16, 2007, a need for 250/500 MW of generation (or generation equivalents) in Zones G-J in 2011, and a need for about 1750MW in 2016, just to maintain

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<sup>6</sup> A statewide IRP process will add new and important dimensions to planning absent from the NYISO's processes. The output from a statewide IRP will not hinder the NYISO in addressing its mission, but assist it.

<sup>7</sup> Additional renewable facilities have been built, and there are more in the NYISO's queue, awaiting system impact studies. Even with the present RPS program, however, it will be a considerable period of time before renewable facilities produce a large amount of power. Most of these proposed facilities are wind driven and will not provide reliable capability at their stated name plate values due to wind variability.

minimum reliability criteria.<sup>8</sup> The NYISO's conclusions generally corroborate the concerns expressed by Central Hudson in its December 2006 reply comments in Phase I of this proceeding. Needs for additional new generation or transmission equivalents are also shown in the scenario analyses set forth in the RNA Report, in relation to potential NUG retirements, coal plant retirements and deferrals of possible new resources.

The 15x15 policy, the proposal of a statewide IRP, and the Commission's Efficiency Case address these needs. The 15x15 policy and the Efficiency Case address potential load growth, and through emphasizing the potential development of demand-side resource opportunities, seek "negative load growth."<sup>9</sup> A proper statewide IRP process, among other things, would evaluate both supply-side and demand-side resource alternatives on a rigorous, consistent, and coordinated basis. A proper statewide IRP would include considerations extending beyond electric system constraints and reliability criteria to embrace economics and important public policy considerations (that will be developed as part of the IRP design process and included within the IRP analyses), to identify when and where additional generation, transmission and demand side resources would be justified.

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<sup>8</sup> The RNA study is related to reliability criteria only, and does not address an optimal resource expansion plan, or economics, fuel type or other generation characteristics or impacts.

<sup>9</sup> The 15% reduction in forecasted loads envisioned by the 15x15 policy equates to over 5000MW, which is more than the 3300MW in load growth between 2007 and 2016 forecast in the NYISO Report.

The IRP process is expected to include optimization analyses of supply-side and demand-side resource alternatives for meeting future energy needs. The IRP is expected to result in a "Plan" that describes (based on up to date information) reliable demand and energy load forecasts, the existing supply-side and demand-side resources and the extent to which those resources will continue to be available to satisfy the forecast demand and energy requirements, as well as the "needs" for additional supply-side and demand-side resources, by forecast year and, where relevant, by location. By analyzing the supply and demand side alternatives quantitatively and in an integrated fashion, the IRP Plan is expected to articulate the State's broad energy policies in a coordinated fashion.

The Plan can be a resource for all: it can inform policy makers; it can facilitate independent actions by lightly regulated generating companies; it can assist market participants in evaluating the fashions in which they may wish to respond to NYISO planning or resource initiatives.

The seeming intractability of the last decade's challenges to adequate, reasonably-priced and reliable energy supplies suggests to Central Hudson that it is time for a different approach. In the last decade, generating companies have constructed about 5500MW of gas-fired combined cycle plants in

New York.<sup>10</sup> One effect of these plants has been to increase reliance on natural gas, which now provides nearly 40% of the energy produced annually in New York. There is also a known need for additional generation both to replace retiring units and meet load growth (assuming that the 15x15 policy and the Efficiency Case will be reasonably successful in tempering load growth).

Hence, the State now faces an undesirable fuel mix, from both a security of supply and a risk of cost increases standpoint, an ageing portfolio of generating stations, ever-tightening environmental restrictions, a clear need for additional capability under current load forecasts, a desire to minimize costs to consumers and an off-setting desire to encourage new supply (at what will likely be higher costs than existing plants), a desire to maintain reliability, an intention of reducing greenhouse gas emissions,<sup>11</sup> a desire to reduce environmental impacts, and a NYISO market design that appears to provide insufficient price signals to stimulate sufficient new, fuel-diverse generation commitments. The rigorous quantification and assessment of long-term costs and societal

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<sup>10</sup> Absent change in public policy to require that factors now "externalized" in the markets become "internalized," that is, integral parts of decisions on when, where and how to build new electric generating plants, there is no reason to expect change in the types of plants that generating companies would construct.

<sup>11</sup> Case 07-M-0548, Order Instituting Proceeding (Issued and Effective May 16, 2007) at notes 7 and 8, and accompanying text.

benefits of various energy supply and demand reduction options within the structure of a statewide IRP offers a way of analyzing these challenges coherently and of gaining insight on desirable solutions.

This proceeding, although addressing thus far only one of three interrelated components, presents a number of questions. Given the emphasis in the Commission's Order on supply-side alternatives, the basic questions might be phrased as: Should we continue to presume that market incentives will produce needed new plants? By the time they are needed? Without any significant reliability or cost impacts to consumers? Alternatively, should the State turn to an IRP, to direct the kind of generation and transmission facilities that should be built, and should it stimulate their construction? These alternative formulations may seem to involve diverging from fidelity to market-driven generation additions and entering onto a path of "central planning." However, the Commission already departed from purely market-driven solutions to new capacity additions when it adopted its RPS Program to provide above-market revenues to renewable facilities to meet the public policy goal that such facilities be developed, and when it proposed to consider mandatory long-term contracts to facilitate new supply.

Hence, the correct question is: Given the present situation, what further interventions by the Commission are likely to provide for the development of new resources in ways that balance the State's (sometimes competing or conflicting) objectives of lowest reasonable achievable costs to consumers, assuring the highest levels of reliability, minimization of environmental impacts, improved fuel diversity and energy security, and other objectives?

#### A Notable Omission

The Commission's April Order does not describe any role for regulated utilities in the generation sector. If this omission was intended to preclude them from future participation in generation, the Commission should reconsider that intention.

Regulated utilities and the Commission have a shared responsibility to provide safe and adequate service. The regulated utility side of that responsibility is the utility's obligation to serve; the Commission's to provide rate support for prudent decisions. The utility's obligation has entailed the responsibility to evaluate all prudent options and select combinations that offer appropriate balances of risk and costs. However, utilities cannot be expected to carry the same responsibility into the future in the face of a Commission decision to exclude regulated utilities from the generation sector, as that alternative would have been eliminated.

As discussed subsequently, regulated utility construction of new generation offers potential cost, and other, advantages to consumers that generating companies are unlikely to provide. In addition, generating companies have avoided plants other than gas-fired combined cycle (and are likely to continue to do so), and there is no known fashion in which the Commission might direct a "lightly regulated" generating company to invest in a project found "needed" in a statewide IRP, whereas that option does exist as to regulated utilities. Providing the assurance that the potential conclusions of a statewide IRP will be attained is, in and of itself, a sufficient basis to include regulated utilities as fully enabled participants in the generation sector, but there are other benefits, as discussed subsequently. Therefore, the evaluation of long-term contracts to "facilitate entry of new supply" should take place simultaneously with evaluating regulated utility provision of new supply. Either option may offer advantages in a given situation. Supply flexibility should be retained by establishing both options as equally available for application, singly or in combination, to meet IRP-defined needs for supply side resources.

#### Statewide IRP

The April 17 Order relates that the Commission has "consistently endorsed competition where it is more effective

than regulation, [and it] also realize[s] that markets alone may not automatically satisfy a broad range of public policy needs and goals." However, there is no longer room for doubt about whether "markets alone" satisfy public objectives. A decade of experience has already established that competition is not effective at all, when it comes to making balanced decisions that incorporate the full range of relevant social and economic factors.

In contrast, the IRP concept entails the idea that factors presently "externalized" (e.g., environmental impacts, fuel diversity and security, energy efficiency and DSM) should be "internalized," and fully recognized, in decisions on what kinds of resources should be pursued to the anticipated "needs" for power. The value of an IRP is that the consideration of supply-side (including transmission) and demand-side alternatives is done together, or "integrated," and that all of the relevant factors, including currently externalized factors that should be internalized, are brought to bear in a systematic way in evaluating all supply-side and demand-side alternatives in relation to each other.

Central Hudson supports the establishment of a statewide IRP. Central Hudson supports the evaluation of supply-side (generation and transmission) and demand-side (energy efficiency, DSM, dispersed generation, load control)

alternatives together, in a rigorous, consistent, and comprehensive quantitative fashion in the statewide IRP.<sup>12</sup> The output from the IRP should be a statewide "expansion plan" that identifies by forecast year the level of each of the resource types and, to the extent relevant, the desired locations for them.

Central Hudson has set forth its views on some details of how the IRP should be developed subsequently, in response to the Commission's questions.

Presumably, the load forecast portion of a statewide IRP would be informed by the NYISO RNA results, but will include analyses addressing the 15x15 policy and the Commission's pending Efficiency Case, to update forecast loads on the basis of the most current, reliable information.<sup>13</sup>

The commitment of significant public (and private) resources that will be required to develop a statewide IRP is appropriate, provided that, at the end of the day, resources found to be "needed" in the IRP will actually be built or, in the case of demand-side resources, obtained. The Commission and regulated utilities have a shared responsibility for safe and

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<sup>12</sup> The Commission's May 16, 2007 Order Instituting Proceeding in Case 07-M-0548 summarizes "preliminary" cost/benefit work done by DPS Staff, showing, according to the Order, that increased energy efficiency is desirable.

<sup>13</sup> Virtually all of the analytical effort described in the May 16, 2007 Order in Case 07-M-0548 is actually the kind of effort called for as part of a statewide IRP. If Case 07-M-0548 were to be conducted separately from a statewide IRP, the IRP would not be "integrated," and the Case 07-M-0548 results of dubious validity. These considerations lead to the conclusion that Case 07-M-0548 should be consolidated with this proceeding.

adequate service, and regulated utilities are the only entities that may be directed to fill a "need" identified in a statewide IRP. Given the evidence of the past decade, it is doubtful that "lightly regulated" generating companies will commit to develop generation other than gas-fired combined cycle (or RPS-supported wind), even if found to be "needed" as the result of a statewide IRP, and even if long-term contracts are available unless those contracts are highly remunerative.

As a result, lightly regulated generating companies and regulated utilities alike should be equally eligible to fill generation needs identified in the statewide IRP. Regulated utilities should be provided with up-front legislative or regulatory commitments to long-term rate relief on a basis equivalent to the up-front reliability of long-term contracts that would be available to generating companies.

The capital-intensive nature of power plants, together with the lower return requirements/capital costs, and other financing cost advantages of a utility, indicate that the regulated utility option may be the only choice in some contexts, and a lower cost scenario than lightly regulated generating company construction in others.<sup>14</sup>

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<sup>14</sup> Conversely, use of long-term contracts may be a higher cost alternative, unless there is legislation or sufficiently reliable regulatory commitments to persuade the rating agencies that long-term contracts' have minimal debt equivalent costs.

## Individual Utility IRPs

Regulated utilities have the responsibility to satisfy the obligation to serve through evaluating all prudent alternatives, including entering into contracts for supply with generating companies, ownership of generation and purchasing from the power markets.<sup>15</sup> The utilities' portfolio management activities take place in a "least cost" paradigm, where "least cost" has consistently been understood to mean lowest reasonable costs over time, while constraining volatility to an appropriate degree, yet seeking the flexibility needed to respond to changing circumstances. The utilities have the responsibility to build flexibility into their portfolio activities, through varying their use of the alternative types of supply sources, as conditions vary, to serve their customers' power requirements and manage their costs.

A stated objective of the Commission's consideration of a statewide IRP is to evaluate bringing currently externalized "public policy factors" into the development of an optimum expansion plan for transmission, generation and demand-side resources. Deliberate incorporation of public policy factors represents a departure from "least cost" planning in the sense that the objectives of least cost planning are amplified and supplemented with the integrated consideration of public policy

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<sup>15</sup> Financial hedges and other financial instruments may also play a role in a utility's supply portfolio.

factors. Appropriate planning objectives of flexibility to respond to changing circumstances, and limiting customer bill volatility are not eliminated; they remain legitimate planning objectives.

However, because a statewide IRP necessarily entails additional factors, it becomes both necessary and desirable for utilities, when addressing their own portfolios, also to conduct their own individual IRPs (after the statewide IRP is completed) to bring the same factors into their individual resource planning. These individual utility portfolio decisions, through an individual utility IRP, would then also represent similar departures from "least cost" planning, through the addition of "public policy factors," but not the elimination of objectives of appropriate planning flexibility, bill volatility mitigation and cost management. Nonetheless, just as a statewide IRP may produce a statewide resource plan that departs, perhaps noticeably, from the plan producing minimum economic costs, individual utility IRPs may well produce individual utility portfolios that depart from lowest economic costs. As a result, utility IRPs and utility portfolio decisions implementing their individual IRPs should be made with the involvement and agreement of the Commission, and with the assurance of cost recovery for those decisions, so that the utilities' costs of capital can be minimized for the benefit of customers.

### Long-Term Contracts

When Central Hudson divested its interests in generation, it retained "long-term contracts." Those obligations were viewed by Central Hudson as reasonable because of the fact that the facilities existed and had known operational characteristics. Those contracts were viewed by Central Hudson essentially as hedges against market risk.

The "long-term contracts" being addressed in the present proceeding are, however, of a different nature. As explained by the Commission, these long-term contracts are intended to facilitate new supply. These long-term contracts would be entered into before the facility is operational (or even constructed), there would be a period of years between the execution of the contract and first potential delivery of power from the operational facility, and the operating success of the facility would be unknown for a period of time. Within the licensing or construction period, the sponsoring generating company counter-party may undergo reorganization, or its financial characteristics could deteriorate over time. These characteristics equate to risks, and the risks must be borne by some party and they must be compensated in some fashion. While Central Hudson is not necessarily opposed to long-term contracts between regulated utilities and generating companies, the case

showing the advantages to ratepayers of long-term contracts has not yet been made.

Although the term, and other terms and conditions of the potential long-term contracts are not known in detail at the present time, it is apparent that for long-term contracts to "facilitate new supply," they must offer economic benefits to lightly regulated generating company developers, compared to the present situation.<sup>16</sup> To induce the generating companies to commit to new supply in the future through long-term contracts, it appears that either the present value of the long-term contract must exceed the PV of the generator's forward price curves (which are currently insufficient to induce new construction), or the long-term contract must reduce the generator's capital costs and required internal rate of return/discount rate enough, so that new investment can be justified at the current forward price curves through reduced financing costs. In the former case, cost increases to consumers are inevitable. In the latter case, it is difficult to see advantages to consumers, as compared to construction of the identical facility by a regulated utility, which will have

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<sup>16</sup> Contracts with a third party transfer risks and therefore are a source of risk. Under past regulatory practices, utilities were not compensated for assuming the risk of project failure, and several utilities' investors paid large sums to settle controversies involving those risks. Another problem was that the contracts themselves became "assets" that erstwhile developers used to negotiate settlements favorable to the developer not to build the project.

lower costs of capital/internal rate of return/discount rates than a generating company.<sup>17</sup>

Lightly regulated generating companies seek to earn unregulated returns, as compensation for the risks of entering into the markets. Under long-term contracts, the risks and rewards of generating company projects financed through long-term contracts are shifted from the generating company to others in an asymmetrical fashion. If a generating company project supported by a long-term contract is successful and profitable, all of the profits are retained by the developer. If the project is unsuccessful, the risk of loss falls on the customers, through the utility counter-party to the long-term contract, or the utility if the risks are not properly alleviated through governmental action.

Regulated utilities do not seek unregulated returns, but mandating entry into long-term contracts forces utilities to assume market risks, just as does the utility build option. A difference between the long-term contract option and the utility-build option is that the risks and rewards of the utility-build option are symmetrical. If the project is successful, customers realize the economic advantages. If the

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<sup>17</sup> As capital costs predominate in new base load plants, and as all operators buy fuels in competitive markets at equivalent or nearly equivalent prices, there is little potential for any assumed efficiency advantage of generating company operations, as compared to utility operations, to produce significant enough cost advantages to offset utilities' lower financing cost and required return/cost of capital advantages.

project is unsuccessful, customers receive the increased costs (assuming an absence of imprudence).

Under current Commission practices, electric utilities are permitted to earn a return on their delivery assets (along with whatever production assets they may own, which are believed to be minor at most, if not de minimis). However, utility electric delivery revenues are significantly less in Central Hudson's case than electric commodity revenues. Entering into long-term commodity contracts for a significant portion of their loads can expose the utility to contractual risks that are leveraged relative to the utility's earning base. Compensation for these risks will be required in any event. The degree of compensation would be a function of the relative utility delivery/third party commodity revenue streams, so that, should utilities invest in generation, the relative portion of third party revenues would tend to be reduced.

Long-term contracts may impose capital cost increases on the regulated utility from the third-party leveraging of utility balance sheets, dependent on the nature of the obligation and the degree of assurance of cost recovery by the utility for the costs of the contract. If the utility's costs are increased, the increase will affect the costs of financing all utility infra-structure (generation, transmission and distribution).

Entry by a regulated utility into a long-term contract with a generating company would shift several material risks from the developer to the utility. With the experience of past New York State policies fresh in their minds, utilities should not be expected to support long-term contracts absent compensation for the risks and protection to their investors, of equivalent reliability to a contract.

Lightly regulated generating companies are seeking to earn unregulated returns that can exceed regulated returns by wide margins, and at the same time be protected against certain risks through long-term contracts. Utilities do not seek unregulated returns, but they seek equivalent protection against risk in relation to reward, should such contracts be required. If the Commission expects regulated utilities to bind themselves to long-term contracts with third parties, the Commission should expect to bind itself reciprocally to long term rate relief to the utility, on terms equivalent to a contractual obligation. Absent that kind of reciprocal support, regulated electric utilities cannot be expected to enter into long-term contracts.

No policy related to long-term contracts should be considered without simultaneous consideration of a comparable policy related to long-term rate commitments of equivalent reliability to the long-term contracts (through either

legislative or regulatory action) to facilitate the regulated utility-build option discussed above.

Utilities should consider entry into long-term contracts (along with utility-build and market purchase options) as part of their individual IRPs. Those plans should be reviewed and approved by the Commission. Utilities proposing to enter into a long-term contract or utility-build option should be provided with up-front review and approval by the Commission as prudent obligations that will be fully and timely reflected in rates.

#### And In The Meantime?

As pointed out by Central Hudson's December 2006 reply comments in Phase I, and as confirmed by the March 2007 NYISO Report, there is a short-term need for significant infrastructure additions to meet reliability-driven capacity requirements in southeastern New York beginning in year 2011, and on a statewide basis in 2012. More gas-fired combined-cycle generation could be built to meet those needs, but the last decade's *laissez faire* policies have invited the cheapest, lowest risk alternatives to be built, just as economic theory predicts, and the fuel mix in the State is already tipped too strongly towards natural gas.<sup>18</sup> Alternatively, it is possible that the 15x15 policy and the Commission's Efficiency Case could

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<sup>18</sup> Fast tracking more gas-fired generation could provide generating capability in the near-term, but at a long-term price.

have beneficial effects in reducing loads, but those effects are not likely to be significant in the near-term future.

The hard reality is that the State needs the diversification of generating facility fuel types that can be achieved only through long lead time clean coal or nuclear base load facilities. Delaying consideration of this problem is equivalent to a decision in favor of further gas-fired generation and in favor of fuel supply and energy price volatility risks. Time is short, and those options should not be further disadvantaged through further delay in confronting this reality now, even as a statewide IRP process moves forward.

#### Conclusion

Regulated utilities should have the option to satisfy the obligation to serve through ownership of generation, through entering into contracts for supply with generating companies, and through purchasing from the NYISO (spot market purchases).<sup>19</sup> They should have the flexibility to vary their use of these alternative supply sources, as conditions vary, to serve their customers' power requirements. Supply portfolio decisions by regulated utilities should be made with the involvement and agreement of the Commission and with the assurance of cost recovery for those decisions (all presumably through an

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<sup>19</sup> Financial hedges and other financial instruments may also play a role in a utility's supply portfolio.

individual utility IRP process), so that the utilities' costs of capital can be minimized for the benefit of customers.

#### RESPONSES TO THE COMMISSION'S QUESTIONS

##### Question 1):

Should there be a statewide integrated resource planning process to examine long term electricity resource needs?

- a) To what extent or in what manner would a statewide integrated resource planning process build on or parallel existing reliability planning processes?
- b) What time frame should be examined in such a process and what issues should be considered?
- c) What is the role of the utilities and other interested parties in the process?
- d) How should the process differ from any previous integrated resource planning processes?
- e) What processes should be adopted, if any, to ensure that resource portfolios at the utility and statewide level, satisfy overall planning objectives and public policy considerations?
- f) How should immediate concerns and long range considerations be addressed?

##### Central Hudson's Response:

There should be a statewide IRP process to examine long term electricity resource needs and to select an optimum generation and transmission "expansion plan" based on consideration of updated load forecasts, anticipated efficiency/demand side options, and other relevant public policy factors, including factors beyond generating companies' forward price curve fore-

casts. The current over-reliance on gas-fired generation is highly undesirable, although it is better than not enough generation to sustain system reliability.

There is, however, no point to commencing an IRP process unless there is assurance that the facilities found to be "needed" will actually be built. For the range of generation and transmission facilities likely to be found to be "needed," that assurance can be obtained through providing that regulated and lightly-regulated entities are equally eligible to fill any generation "need" identified in the IRP process. The utilities' obligation to serve calls for active engagement in considering all reasonable options for meeting customers' power requirements, including potential participation in constructing generation when in customers' interests. Regulated utilities are not mere "backstops" against which stray generation needs might occasionally and randomly bounce.

To the extent that resource types other than gas-fired combined cycle generating plants are called for in the IRP, history indicates that it is highly unlikely that lightly-regulated generating company entities will provide them, unless regulatorily-mandated long-term contracts are so remunerative to the generating company as to fully compensate it for its perception of the risks. Any such contract is likely to be quite costly. Once entered into, the risks of those contracts

would be largely transferred to the utility counter party, potentially impacting its costs of capital, to the detriment of customers over time. As a result, if the costs and risks are to be avoided, regulated utilities will be required to develop such facilities. The existing prudence mechanism empowers the Commission to direct regulated utilities to fill the need; no such mechanism exists as to lightly-regulated entities. To make construction financially feasible, reasonable rate support to the utility over the term of the project is needed, along with a clear and firm long-term commitment (equivalent to a contractual obligation) on the front end. While the commitment could be provided by new legislation, state agencies generally have an ability to enter into contractual obligations that bind the State under current law.

a) Existing reliability planning processes conducted by the NYISO are largely reliability-driven. The NYISO is expected to expand its current planning processes, and may include economic planning studies, including forecasts of congestion costs. If information from these activities is available in a timely fashion, it could be utilized in the IRP process.

However, if information already developed, or to be developed, for the NYISO's planning is not available to be utilized in a statewide IRP, the IRP process should proceed forward and not be delayed awaiting possible future activities

by the NYISO. It is likely, in Central Hudson's view, that there will be a need in a statewide IRP to create data bases from several different sources that will integrate with each other and be susceptible to optimization studies.

As noted previously, the Commission has a statutory mandate to assure safe and adequate service. Accordingly, there is no legal impediment to Commission action to develop a statewide IRP.

Neither the FERC, nor the NYISO (nor NYSRC) has "preempted" the field of electric planning. While the FERC has approved the NYISO tariffs calling for an NYISO planning process that includes "backstop" solutions by transmission owners, when and if required, nothing in the NYISO tariff or NYISO process calls for consideration of public policy factors alluded to in the April Order. Since the State has an independent, *parens patriae* responsibility for the safety and welfare of its citizens, and factors it has determined relevant to its authority are not included in the NYISO's planning, the Commission may exercise its responsibilities under the Public Service Law to assure safe and adequate service through determining what facilities will further the public health and safety.

b) Central Hudson believes that ten years is the minimum planning horizon that should be considered. Use of a ten- to twenty-year planning horizon has been shown to balance

foreseeability and practicality. As the lead times for forms of generation (other than gas-fired combined-cycle or renewables) approximate ten years, the IRP should include the twenty-year horizon.

c) All involved (utilities, ESCOs, generators) will have some responsibility to provide information in formats that facilitate IRP analyses. While these data could once have been obtained from a relatively few vertically-integrated entities, the Commission's decision to restructure the industry means that many more organizations will necessarily be involved in the development of data sets, and that ways to alleviate legitimate concerns for competitively sensitive and infrastructure security-sensitive information will need to be developed (and implemented).

For example, regulated utilities have unique data sets (e.g., transmission and distribution costs, customer load and load shape data), knowledge and experience to draw upon in assessing their system requirements. However, regulated utilities have no corner on knowledge about the extent of customer/load migration. ESCOs have unique knowledge of their customers' characteristics, their own marketing, and their expectations for success in inducing customer migration. Generators have unique knowledge of their operations and plant characteristics. All of the above knowledge will have to be

quantified, systematized, and utilized (subject to confidentiality concerns) to develop reliable inputs to the IRP process.

Other inputs will also be required. For example, some rigorous and systematic way of quantifying environmental externalities and other public policy factors relevant to the analyses is needed. It appears to Central Hudson that a "collaborative" stage of the proceeding will be desirable to specify the inputs for the analyses, and the various persons/organizations responsible for developing them. The inputs that are needed will be a function of the analyses to be produced. Therefore, an early task will be to determine the forecasting tools that will be used. A collaborative is also recommended for this task. At least one Administrative Law Judge should supervise the collaborative.

Initial work on the analytical models and on the inputs can take place in parallel to a significant degree. There should be a full specification in the collaborative of the "cases" to be studied, as well as of the IRP modeling.

DPS Staff should produce a proposed or preliminary draft statewide, integrated report for review and discussion in the collaborative. Parties should have a reasonable opportunity to make discovery as part of the review process. Recommendations concerning the preliminary draft should be developed to the

extent possible through consensus (and every party should have the right to join or not in a proposed consensus position, without prejudice to its rights to present its views directly to the Commission). The Commission should consider the parties' recommendations and issue either a new draft, or a final IRP Plan document, identifying "need" and location (by area) for generation (or demand side) resources and transmission facilities, by forecast year.<sup>20</sup>

d) The restructuring of the electric utility industry by the Commission, subsequent to earlier IRP efforts, makes comparisons to those efforts not particularly instructive. The current IRP should be evaluated on its own merits, and not necessarily by reference to prior activities.

e) Steps must be taken to preserve the objectivity, transparency and reliability of the IRP process. The first necessary step is that each appropriate "planning objective" and each "public policy consideration" must be articulated, weighted relative to every other factor, and valued in a consistent fashion. This evaluation must be made at the start of the process, as an input, to preserve the objectivity of the results.

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<sup>20</sup> Once a statewide IRP Plan has been issued, utilities can utilize the expansion resource plan as a source of information for their own portfolio management and individual IRP activities.

f) Immediate and long range considerations are accounted for through identification of each relevant planning consideration as part of the design of the IRP process, and the inclusion of each aspect determined to be relevant (whether immediate or long range) in the analyses. All factors, whether immediate or long range, should be included and evaluated within the analyses, and there should not be any "post-processing."

Question 2):

Should major regulated electric utilities be required or encouraged to enter into long-term contracts, with existing generators, proposed generators, and other entities, that facilitate the construction of new generation, the development of additional energy efficiency, the development of additional renewable generation resources, the re-powering of existing generation, or the relief of transmission congestion?

a) Should such contracts be entered into for the purposes of improving fuel diversity, mitigating market power, or furthering environmental policies?

Central Hudson's Response:

Contracts between a regulated utility and a third party generator are one of several available mechanisms for supply to the utility's customers. Regulated utilities have an obligation to serve. They meet that obligation through portfolio management, and utilize purchase contracts as one element of their portfolio strategy.

They should have the flexibility to satisfy that obligation through ownership of generation, through entering into contracts for supply with generating companies, and through purchasing from the NYISO (spot market purchases). They should have the flexibility to vary their use of these alternative supply sources as conditions vary, balancing consideration of cost, reliability, volatility reduction and other objectives.

Supply portfolio decisions by regulated utilities should be made with the involvement and agreement of the Commission, and with the assurance of cost recovery for those decisions, so that the utilities' costs of capital can be minimized for the benefit of customers.

To the extent that the Commission wishes regulated utilities to deviate from least-cost supply portfolios to attain public policy purposes, it should require individual utility IRPs that are reviewed and approved by the Commission. It would be expected that the individual utility IRPs would be generally consistent with the principles incorporated into the statewide IRP, and apply those principles to the unique situation faced by the utility.

In addition, if the Commission expects regulated utilities to bind themselves to long-term contracts with third parties, the Commission should expect to bind itself reciprocally to long-term rate relief to the utility, on terms equivalent to a

contractual obligation.<sup>21</sup> Absent that kind of reciprocal support, regulated electric utilities cannot be expected to enter into long-term contracts.

Any or all of the considerations posited in the question may represent legitimate public policy goals and should be included among the factors to be weighted and valued relative to all other such factors as inputs to the statewide IRP process. The statewide IRP should be the mechanism used to determine the effect of those considerations, together with all other relevant factors, as part of the development of the optimum expansion plan. The IRP Plan will, therefore, reflect all of the relevant factors through the resources specified in the Plan. Contracts should be directed towards those resources, as explained herein, and not toward resources that are not part of the IRP Plan.<sup>22</sup>

Question 3):

Should Load Serving Entities other than utilities, including the New York Power Authority and the Long Island Power Authority, be required or encouraged to enter into long-term contracts as described above?

a) What role, if any, might entities other than Load Serving Entities play in such resource procurement?

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<sup>21</sup> Analytically, it would be expected that the utility should receive regulatory commitments of greater reliability than the contractual long-term commitments between utility and generating company, because the utility's return potentials are limited.

<sup>22</sup> Nothing in the IRP process or Plan should prevent an entrepreneur from developing a project in the usual way, through private financing and private contracts with customers. The effect of the IRP is to limit mandated contracts to those resources found desirable through being included in the expansion plan.

Central Hudson's Response:

If an obligation is established by the Commission to the effect that any LSE should support lightly regulated generators through long-term contracts, the same obligation should apply to all load serving entities and all load serving entities should have the same obligations. Just as regulated utilities should develop individual IRPs should the Commission decide to depart from least cost supply planning, it would not be objectionable if public entity LSEs had the option (also possibly through their own individual IRPs) to serve legitimate public policy objectives through entering into contracts for such purposes, as long as the contracts were for resources found to be "needed" in the statewide IRP.

Question 4):

Should resource procurement, as described in Question 1, be coordinated on a statewide basis?

a)What regulatory oversight, if any, would be appropriate?

Central Hudson's Response:

To justify the expenditure of the significant public (and private) funds, time and resources that will required to develop an IRP, it is critical that the determinations of the IRP be attained. Therefore, both lightly regulated generating companies and regulated utilities should have equivalent

opportunities to respond to generating plant "needs." The Commission can exercise its ratemaking and other authority over regulated utilities for that purpose, should that prove necessary. In effect, the Commission will be able to assure that the recommendations of the statewide IRP are being implemented, and resources procured in a coordinated fashion, through requiring the affected utilities to respond to the IRP, or explain why not responding is not imprudent.

As noted previously, individual utility IRPs that will "bake into" utility planning the same public policy considerations employed in the statewide IRP are also anticipated. The utilities will then be motivated by similar "valuations" of the public policy considerations, and be in a position to apply them to their own, individual circumstances. Legislative or regulatory commitments to the utilities, of equivalent scope and reliability to those expected by lightly regulated generating companies in long-term contracts with the utilities, will establish parity of treatment. In addition, it will allow the better alternative (as between utility-sponsored or generating company-sponsored proposal) to prevail, in the event that both a utility-build and a generating company-build proposal are made.

Question 5):

What barriers, if any, exist that discourage long-term contracts for development of new electricity resources?

a) What other barriers exist, if any, for the development of new electricity resources?

b) Should incentives beyond what exist today be created to encourage entry into long-term contracts generally, or to foster the development of any particular type of resource?

c) How could those incentives be structured consistent with the goal of acquiring the most cost-effective resources?

Central Hudson's Response:

There are fundamental questions as to the desirability, efficiency, effectiveness and appropriateness of long-term contracts between a regulated utility and a generator. The case showing that long-term utility/generating company contracts are the best alternative for facilitating new generating plants has not yet been made.

One barrier to utility participation in long-term contracts is uncertainty as to load obligations in the face of on-going retail load migration. Inasmuch as generating companies have the opportunity sell into a diversified statewide market, that risk is attenuated for them.

Other barriers relate to the potentially, or even necessarily, above-market nature of the proposed contracts, properly pricing the risks allocated in the contract, addressing the asymmetrical risks contained in such contracts, and

eliminating the risks of regulatory second-guessing for contracts that turn out to be economically undesirable after a period of time, as conditions change. The prior history of mandated power contracts in New York has shown that utilities can be put at major financial risk through such contracts. Therefore, regulated utilities are not necessarily likely to sign on to a significant long term contract without up-front, reliable regulatory commitments of recoverability of the costs to be incurred under the contract. Utility managements have fiduciary responsibilities to their shareholders, and may not enter into obligations that may impair the value of the entity.

The Commission should not expect utilities to do for generating companies what the Commission will not do for utilities. If the Commission expects utilities to enter into reliable long-term obligations that can be enforced by the generating company against the utility counter-party, the Commission must itself enter into equivalently reliable long-term obligations with utilities that can be enforced by the utility against the Commission.

Another barrier relates to the cost-producing potential of such contracts. For a long-term contract to offer an advantage to a generating company developer, it must either provide a commitment to buy at prices that exceed the generating company's forward price curve, reduce the generating company's financing

costs/required returns, or both. As discussed above, those features represent cost impacts to consumers, and should be evaluated in comparison to the costs of the utility-build option.

In addition, it is well-known that the rating agencies will impute debt equivalents into the balance sheet of a utility entering into long-term contracts, based upon the rating agencies' assessment of the recoverability risk faced by the utility. These reviews apply to the individual contract and cumulative financial implications of the utility's obligations. S&P has explained its methods for evaluating short, medium and long term contracts through a NPV analysis of the utility's contract portfolio, including a component for "depreciation expense." The potential effects of debt imputation include increased costs of borrowing, requirements to carry thicker equity component of the capital structure, and requirements for increased return on equity in relation to the risks of the utility's contract portfolio. One of the factors employed by S&P is a "risk factor," which reflects the rating agency's assessment of the likelihood of impairment flowing from the obligations. The provision of an reliable and enforceable, up-front commitment to recoverability (whether legislative or regulatory) is a factor that reduces the risk of the obligations, and the cost consequences of the debt equivalent.

Question 6):

Should constraints be imposed that would, under certain circumstances, restrict the resource types eligible for long-term contracts, limit the length of contract terms or establish the content of other contract conditions?

a) What steps should be taken to limit any anti-competitive impacts long-term contracts might create?

Central Hudson's Response:

By definition, the long-term contracts under consideration in this proceeding relate to new facilities. Assuming that a statewide IRP will be developed, no long-term contract should be provided to any proposed facility that is not "needed," as determined in the IRP.

The bilateral nature of a long-term contract is not inherently "anti-competitive," even though such a contract might tend to remove transactions from certain aspects of the NYISO's markets. If bilateral contracts became so prevalent as to affect the trading in, for example, the hourly markets, a different situation would be presented.

However, as between two lightly-regulated entities, one receiving a long-term contract because it will be a new facility, and the other not receiving one because it is an existing facility, there is a potential for anti-competitive effects because the new facility would have an advantage not

available to the existing facility. It is difficult to perceive what steps might be taken to limit those anti-competitive effects.

On the other hand, it is feasible to limit anti-competitive impacts from long-term regulatory commitments received by a utility relative to developing a "needed" facility called for in the IRP. This can easily be done by establishing bidding rules that the utility must follow in offering the plant's output to the NYISO, and requiring the utility to flow back to ratepayers the excess of market revenues above the cost of service revenue stream determined by the Commission. Assuming the utility-build plant is one satisfying a "need" found in the statewide IRP and has prudently incurred costs exceeding those that can be recovered from the markets, the excess costs would be socialized, in a fashion somewhat analogous to the RPS approach.

Question 7):

Should restrictions or guidelines be imposed on the resource procurement practices employed in selecting the resources that would be acquired under the long-term contracts?

Central Hudson's Response:

Assuming that a statewide IRP will be established, there is no justification for mandated long-term contracts for any facility not "needed" under the IRP.

Utilities should consider long-term contracts as one option to meet the utility's customers' needs for power. However, assuming that individual utility IRPs will be performed, utilities should follow the requirements dictated by their IRPs. They not be required to enter into long-term contracts not required as part of the utility's individual IRPs. Should the individual utility IRP determine that a long-term contract is a prudent option, the Commission should review and, assuming it agrees, approve the selection of such a contract prior to the effectiveness of the contract. An analogous review and approval process should be applied to a utility-build facility. In both cases, the Commission approval should be as reliable and enforceable as the long-term contract.

Question 8):

How should long-term contract costs be recovered from customers, and should different recovery mechanisms be developed based on the type of resource that is acquired under the contract, the length of the contract, or other factors?

Central Hudson's Response:

The full costs of the contracts should be flowed through to customers as incurred through the energy cost portion of the rate structure (ECAM in Central Hudson's case). Depending on the size of the generating facility and the utility's needs, more than one contract involving more than one utility might

support a particular generating company-sponsored plant. No apparent basis for differentiating the timing and degree of cost recovery exists, assuming that the long-term contract relates to a "needed" generating facility, as found in the statewide IRP.

In addition, there can be utility capital cost consequences from entry into a long-term contract, and these costs should also be recovered on an as incurred basis. Long-term contracts are essentially debt equivalents from a financial and economic perspective, but they may also have other cost of capital consequences. Their capital costs should be built into the weighted cost of debt, and the other consequences recognized in the establishment of authorized ROE and capital structure, so that the utility is fully and currently compensated for the costs.

Question 9):

What procedures should be followed in reviewing a long-term contract and in establishing its qualification for cost recovery?

a) Under what circumstances, if any, should recovery of contract costs be pre-approved?

Central Hudson's Response:

Any contract to acquire output from a facility meeting a "need" established in the IRP should be pre-reviewed by the Commission (as part of the review of the individual utility's

IRP) and if found to be justified on a prospective basis, should be "pre-approved."

There is no need to establish a specific new procedure for bringing a proposed contract before the Commission. The Commission's existing procedural mechanisms are already adequate for this purpose.

Question 10):

Can long-term contracts (energy and/or capacity) be harmonized with existing NYISO rules for energy and capacity markets, and with potential NYISO forward capacity markets?

- a) If so, how can they best be harmonized?
- b) What changes to NYISO market rules, if any, would be necessary or appropriate for the purpose of accommodating long-term contracts?
- c) Should NYISO market rules recognize or ameliorate the impact, if any, of long-term contracting on the NYISO capacity prices paid existing generators, or, if amelioration is appropriate, should it be accomplished through non-NYISO mechanisms?

Central Hudson's Response:

It is relatively simple to harmonize with the NYISO's markets the long-term legislative or regulatory commitments to a regulated utility for rate relief to facilitate utility construction of a "needed" generating facility. This can be done by establishing bidding rules to avoid impacting NYISO markets (more than necessary, given the addition of resources to

the supply curve), and by requiring that above cost revenues be returned to ratepayers. To the extent that the new generating plant would not be able to recover all of its costs from the market, those costs should be socialized to all consumers, based on the statewide IRP determination that the facility fills a legitimate public policy function.

It is not obvious how long-term contracts between a regulated utility purchaser and a lightly regulated generating company to support the financing of a new plant should be treated to avoid anti-competitive effects on other lightly regulated generators which are not building a new plant, or on the NYISO's markets.

Question 11):

Are there any other creative solutions that might be considered to address the issues identified herein?

Central Hudson's Response:

Central Hudson believes that regulated utilities should be permitted to build generation, funded through rates, and sell the output in the NYISO's markets, in the fashion described previously. The utility facilities should be expected to operate as effectively as generating company units, and symmetrical regulatory incentives might appropriately be employed to produce that result.

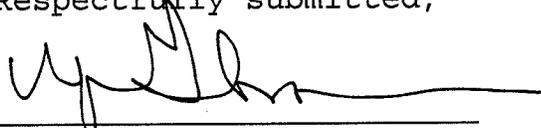
Any excess revenues above cost would be returned to ratepayers. If the type of generating facility is one that has been found needed in the statewide IRP and the costs exceed what are available from the markets, the above-market component would be socialized in a fashion somewhat analogous to RPS costs.

CONCLUSION

Central Hudson supports a statewide IRP, as described above. Central Hudson supports Commission evaluation of the costs and benefits of long-term contracts to facilitate generating company supply side construction together with, and in comparison to, the costs and benefits of the utility-build option for supply side construction.

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Respectfully submitted,



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