

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

In the Matter of the Application of)
HAWAIIAN ELECTRIC COMPANY, INC.)
For Approval of Amendments No. 5)
and No. 6 to the Power Purchase)
Agreement Between Hawaiian Electric)
Company, Inc. and Kalaeloa Partners,)
L.P.)
_____)

DOCKET NO. 04-0320

DECISION AND ORDER NO. 21820

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ATTEST: A True Copy
KAREN HIGASHI
Chief Clerk, Public Utilities
Commission, State of Hawaii.

K. Higashi

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DECISION AND ORDER

The commission approves two (2) amendments between HAWAIIAN ELECTRIC COMPANY, INC. ("HECO") and KALAELOA PARTNERS, L.P. ("KP"), and related matters thereto, for the purchase of up to 29 megawatts ("MW") of additional firm capacity and energy.

I.

Background

HECO purchases firm capacity and energy supplied by KP, pursuant to a Power Purchase Agreement ("PPA"), as amended (the "Amended PPA").¹ HECO seeks the commission's approval of various matters related to Amendments No. 5 and No. 6 (both dated October 12, 2004) (collectively, the "amendments") of the

¹The Amended PPA presently consists of the commission-approved initial PPA and four (4) amendments thereto. See: (1) Docket No. 6378, Decision and Orders No. 10369, 10824, and 11494, filed on October 16, 1989, October 31, 1990, and February 24, 1992; and (2) Docket No. 00-0001, Decision and Order No. 17647, filed on March 30, 2000.

Amended PPA.² HECO makes its request pursuant to Hawaii Administrative Rules ("HAR") § 6-60-6(2).³

HECO served copies of its Application upon the Department of Commerce and Consumer Affairs, Division of Consumer Advocacy ("Consumer Advocate")(collectively, the "Parties").

On February 23, 2005, HECO responded to the Consumer Advocate's information requests. On March 10, 2005, HECO filed its annual Adequacy of Supply Report, dated March 10, 2005 (the "AOS Report"). On March 21, 2005, the Parties held a technical meeting, and on March 31, 2005 and April 22, 2005, HECO filed its responses to the informal information requests posed by the Consumer Advocate during the technical meeting.

The Consumer Advocate does not object to the commission's approval of Amendments No. 5 and No. 6, subject to one (1) condition.⁴ In sum, the Consumer Advocate concludes that: (1) addressing HECO's claimed reliability problem requires

²HECO's Application, Verification, Exhibits A, B, and C, and Certificate of Service, filed on November 5, 2004, as amended by letter dated May 6, 2005 (collectively, the "Application").

Amendment No. 5 is entitled, "Confirmation Agreement Concerning Section 5.2B(2) of Power Purchase Agreement and Amendment No. 5 to Power Purchase Agreement." Amendment No. 6 is entitled, "Agreement for Increment Two Capacity and Amendment No. 6 to Power Purchase Agreement Between Hawaiian Electric Company, Inc. and Kalaeloa Partners, L.P."

³HAR § 6-60-6(2) provides:

No changes in fuel and purchased energy costs may be included in the fuel adjustment clause unless the contracts or prices for the purchase of such fuel or energy have been previously approved or filed with the commission.

⁴Consumer Advocate's position statement, filed on April 13, 2005.

aggressive action at this time; and (2) "HECO's energy and capacity costs under the terms of Amendments 5 and 6 likely are at, or below the costs of other alternatives, i.e., at least those that can bring needed capacity in the near-term."⁵

On April 29, 2005, HECO notified the commission that it will not file a rebuttal position statement, "because it appears that the [Consumer Advocate] does not oppose the approvals and determinations requested by HECO."⁶ On May 6, 2005, HECO filed a revised page 40 to its Application.⁷

II.

Kalaeloa Partners, L.P.'s Facility

KP is a Delaware limited partnership. KP's: (1) general partner and one (1) per cent owner is PSEG Kalaeloa Inc., a Delaware corporation; and (2) limited partner and ninety-nine (99) per cent owner is Kalaeloa Investment Partners, L.P., a Delaware limited partnership.

HECO purchases 180 MW of firm capacity and energy supplied by KP's low sulfur residual oil-fired combined cycle cogeneration facility located at Kalaeloa, Ewa District, Oahu (the "Facility"), pursuant to the Amended PPA. In addition,

⁵Id. at 20 - 21. See also id. at 2.

⁶HECO's letter, dated April 29, 2005.

⁷HECO's transmittal letter, dated May 6, 2005, with attachment. HECO makes certain corrections to page 40 of its Application. Because HECO filed its corrections subsequent to the filing of the Consumer Advocate's position statement, the commission, on its own motion, updates the Consumer Advocate's position to reflect HECO's updated information.

KP supplies process steam to Tesoro Hawaii Corporation ("Tesoro") pursuant to a steam sales contract. KP operates its Facility as a Qualifying Facility.⁸

The Facility consists of: (A) two (2) combustion turbines ("CTs" or "CT"), each with a heat recovery steam generator ("HRSG"); and (B) one (1) steam turbine ("ST"). The two (2) CTs have separate controls and operate independently of each other in almost all aspects. The ST's output is dependent on at least one (1) of the CTs being in operation to provide heat to produce steam with the HRSG.

The Facility's design and structure enables one (1) CT to operate while the other CT is off-line for maintenance. Because of this design, HECO has treated the Facility for purposes of dispatch as consisting of two (2) separate units each of 90 MW.⁹ The 90 MW includes the CT output plus one-half (1/2) of the output of the steam generator.

III.

Summary of the Amended PPA and Amendments No. 5 and No. 6

The Amended PPA provides that KP is obligated to deliver and HECO is obligated to purchase capacity of 180,000 kilowatts ("kW"). The capacity charge is \$164.35 per kW-year for the first 180,000 kW.

⁸See HAR chapter 6-74.

⁹HECO states that it "does not have a specific set of criteria to determine whether the [F]acility qualifies as two separate units or two interdependent units." HECO's response to CA-IR-23, at 2. Rather, it considers a number of factors on a facility specific basis in determining whether to treat a facility as one or multiple units. Id. at 2 - 3.

In addition, Section 5.2(B)(2) of the Amended PPA provides that if KP demonstrates that its Facility can continuously deliver more than 180,000 kW of firm capacity, but not more than 189,000 kW, without changing the Facility's design configuration, HECO must purchase the additional capacity, at the excess charge rate of \$112 per kW-year.

Amendments No. 5 and No. 6, both executed by HECO and KP (collectively, the "PPA Parties") on October 12, 2004, are subject to certain conditions precedent, including the: (1) commission's approval; and (2) consent of KP's Lenders.¹⁰ On December 8, 2004, KP received the Lenders' written consent.¹¹

IV.

Amendments No. 5 and No. 6

Amendments No. 5 and No. 6 address certain issues in the following categories: (A) additional capacity; (B) energy charge components; (C) reliability; (D) capacity evaluation protocol; and (E) financial accounting. In addition, both amendments: (A) memorialize the PPA Parties' clarification and interpretation of certain provisions in the Amended PPA; and (B) update certain attachments to the Amended PPA.

¹⁰HECO explains that the two (2) amendments are separated because: (1) the additional 9 MW under Amendment No. 5 is already being provided pursuant to Section 5.2(B)(2) of the Amended PPA; and (2) of the possibility that the conditions precedent for Amendment No. 5 might occur without all of the conditions precedent for Amendment No. 6 occurring, in which case the PPA Parties will only implement Amendment No. 5.

¹¹See HECO's response to CA-IR-50 (Lenders' Consent, between KP and Ing Capital LLC, dated December 8, 2004.)

A.

Additional Capacity

Amendment No. 5: (1) memorializes the PPA Parties' agreement regarding the application of Section 5.2(B)(2) of the Amended PPA, thereby facilitating KP's increase in firm capacity by 9 MW to HECO;¹² and (2) confirms that the capacity charge for firm capacity above 180 MW up to 189 MW (aka the excess capacity charge) is \$112 per kW-year, as set forth in Section 5.2(B)(2).

Amendment No. 6, meanwhile, represents additional firm capacity of up to 20 MW that KP will supply to HECO, following a modification to increase the mechanical efficiency of each of the Facility's two (2) CTs. This modification process is referred to as the "M Upgrade."

The M Upgrade: (1) on the first CT was completed in May 2004; and (2) on the second CT was completed in December 2004. With the completion of the M Upgrade, HECO represents that energy is currently available to HECO near the 209 MW level as anticipated. The performance test process to determine a level that meets the firm capacity criteria is on-going. KP must notify HECO of the completion and final acceptance of the M Upgrade by June 30, 2005.

HECO explains that "the M Upgrade can result in slightly more than 20 MW of additional generation without any increase in fuel oil consumption. However, the increased power production by the CTs causes slightly less heat to be available

¹²HECO notes that the additional 9 MW of firm capacity "already exists[,]" pursuant to the Amended PPA. See HECO's Application, at 8, footnote 7.

for steam generation for electrical generation in the steam turbine. As a result, some of the increased CT output is offset by the slightly lower steam production to yield an expected net power increase of 20 MW at the maximum."¹³

The capacity charge for the additional firm capacity of up to 20 MW above the 189 MW level is also \$112 per kW-year, pursuant to Amendment No. 6. HECO evaluated and agreed to this charge based on its: (1) need for additional capacity; and (2) estimates of the avoided capacity cost value of the additional 20 MW.¹⁴

HECO states that the Facility will: (1) continue to be dispatched as a baseload plant to serve the increase in demand on HECO's system; (2) at times, be dispatched up to the maximum contract capacity of 209 MW to meet the higher demand on the system; and (3) most likely be dispatched at or near the 209 MW level primarily during the on-peak hours, which correspond to the utility's system's highest loads.¹⁵

¹³HECO's Application, at 9.

¹⁴See HECO's Application, at 15 - 16 (HECO undertook an avoided capacity cost analysis based on the proxy method); and HECO's responses to CA-IR-11 and CA-IR-13.

¹⁵Nonetheless, the Facility "would be available to go to maximum load at any time consistent with the concept of Firm Capacity being available 24 hours per day if the HECO system need to have Kalaeloa at the higher output level." HECO's response to CA-IR-31.

B.

Energy Charge Components

Under Section 5.1 of the Amended PPA, the energy charge consists of three (3) components: (A) the fuel component, with a fuel price adjustment based on the cost of low sulfur fuel oil ("LSFO"); (B) the additive component; and (C) the non-fuel component, with an adjustment based on changes in the Gross National Product Implicit Price Deflator. The fuel and additive components, in turn, are combined together in the ECAC.

1.

Fuel Component

Amendments No. 5 and No. 6 do not change the fuel component.

2.

Additive Component

Amendment No. 5 changes the additive component, due to the discontinuation of the index used in the formula specified under the Amended PPA. Specifically:

i. The additive component represents the cost of the fuel additive needed to minimize the effect of certain constituents in the LSFO from damaging the blades within the CT.

ii. The Amended PPA annually adjusts, for inflation, the additive component by pegging the change in the Producer Price Index for Magnesium ingots (the "Magnesium PPI") published

by the United States ("U.S.") Bureau of Labor Statistics ("Bureau") from the value published for January 1, 1988.

iii. By the end of 2003, the Bureau ceased its publication of the Magnesium PPI. Its last final index value was published for August 2003. Thus, no final index value was published for January 2004 or December 2003. Nonetheless: (1) HECO's position is that the final published value for January of a given calendar year applies for the year; and (2) KP's counter-position is that the final December value for the prior year should apply for the next calendar year.

iv. Due to the discontinuance of the Magnesium PPI in 2003, the PPA Parties "had to agree on the values to be used for 2003 and 2004, the inflation adjuster to be used through the remaining term of the Amended PPA, and the mechanism to transition from the existing inflation index to the new inflation index."¹⁶

v. The PPA Parties ultimately settled these issues as follows: (1) the base of the additive component remains at 0.144 cents per kWh as provided for in the Amended PPA; and (2) changes have been made to replace the Magnesium PPI with a new method of adjusting for inflation. Specifically, the replacement index is the Gross National Product Implicit Price Deflator ("GNPIPD") index, published by the U.S. Bureau of Economic Analysis. This same index is already used to adjust the non-fuel component for inflation. The base date for the GNPIPD used for the additive component will be January 1, 2004.

¹⁶HECO's Application, at 18.

Section 3 of Amendment No. 5 incorporates the PPA Parties' settlement.¹⁷

Amendment No. 6, meanwhile, does not include any changes to the additive component.

The PPA Parties, through the applicant HECO, request that the commission either: (1) approve the PPA Parties' settlement of the additive component issue; or (2) find that the commission's approval of the settlement is not required.

3.

Non-Fuel Component

The non-fuel component established by the Amended PPA, as amended by Amendment No. 2, is 0.96 cents per kWh and is adjusted for inflation by multiplying it by the ratio of the GNPIPD (current) divided by the GNPIPD (base) (January 1988).

The value of the non-fuel component for 2004, as adjusted, is approximately 1.38 cents per kWh. The minimum energy purchase provision in Section 5.1(D) of the Amended PPA requires HECO to purchase 1,235 gigawatt-hours per contract year, provided that the Facility is available for dispatch at an equivalent availability factor ("EAF")¹⁸ of eighty-five (85)

¹⁷See also HECO's response to CA-IR-14. Amendment No. 5 also includes the PPA Parties' settlement of a dispute between them regarding the pricing of the additive component during 2003. The settlement provides HECO with a full refund of the disputed amount, \$555,530, as a credit, beginning in January 2004.

¹⁸EAF measures a generating unit's reliability.

per cent. If HECO does not meet the minimum energy purchase obligation, it must pay a "shortfall" cost.¹⁹

HECO states that Amendments No. 5 and No. 6 do not change the minimum energy purchase obligation, inasmuch as it is unlikely that KP's lenders would have consented to these amendments if one (1) of the economic provisions upon which the lenders financed KP's project was changed. Also, with the proposed increase in firm capacity and the dispatch incentive incorporated in the variable O&M component (discussed below), HECO expects that KP's dispatch will generally exceed the minimum energy purchase obligation.

Incentive Energy: Variable O&M Component

The non-fuel component represents compensation from HECO to KP for the O&M of the Facility. KP seeks to encourage HECO to dispatch the Facility more, in order to maximize KP's operating and fuel efficiencies and potentially increase KP's revenues. Accordingly, the PPA Parties agreed on a new rate structure for the non-fuel component that "significantly lowers" the cost to HECO and its customers, once the minimum energy purchase obligation is met.

¹⁹HECO explains that: (1) the total "shortfall" cost represents the non-fuel dollar amount of the difference between the kWh amount dispatched and purchased by HECO and the available energy, should HECO not purchase all of the energy made available by KP, up to the minimum energy purchase obligation; and (2) the shortfall provision was based on the costs that KP would incur for operations and maintenance ("O&M") (i.e., the non-fuel component) and for fuel not purchased under KP's steam sales contract with Tesoro if HECO did not purchase the minimum amount of energy specified; and (3) the shortfall provision was necessary and reasonable given HECO's absolute dispatch control over the Facility.

The new rate structure, known as the Incentive Energy provision, is set forth in Section 4(A) of Amendment No. 5, and modifies Section 5.1(E) of the Amended PPA. The Incentive Energy provision changes the energy charge formula once the minimum energy purchase obligation for a contract year is met, by replacing the non-fuel component with the variable O&M component. HECO describes the discounted rates under the variable O&M component, as follows:

The Variable O&M Component (prior to adjustment by GNPIPD) agreed by the [PPA Parties] in Amendment No. 5 is 0.48 cents per kWh when the dispatch level of the Facility is below 180,000 kW, which represents a **discount** of 50% from the 0.96 cents per kWh Non-Fuel Component value, and is 0.144 cents per kWh when the dispatch level is at or above 180,000 kW, which represents a **discount** of 85% from the 0.96 cents per kWh Non-Fuel Component value. The 0.48 cents per kWh and 0.144 cents per kWh values are also adjusted for inflation by multiplying them by the ratio of GNPIPD (current) divided by GNPIPD (base) (January 1988).

The value of this component for 2004, as adjusted, when the dispatch is below 180 MW, would be approximately 0.69 cents per kWh, and when the dispatch is at or above 180 MW, would be approximately 0.207 cents per kWh.²⁰

HECO explains that the application of the variable O&M component in place of the non-fuel component, in most cases, will be performed after-the-fact because the minimum energy purchase obligation is dependent upon the contract year EAF, which is not determined until the end of the contract year (which occurs in May, not December).

²⁰HECO's Application, at 24 (emphasis added). See also Section 4(A) of Amendment No. 5.

C.

Reliability

With the increase in firm capacity from 180 MW up to a maximum of 209 MW, HECO reviewed additional measures to minimize or avoid the potential for the entire Facility to suddenly trip off-line, i.e., a full plant trip. HECO states that KP has taken substantial steps to prevent the recurrence of equipment failures and operator errors that may cause a full plant trip. As a result of KP's commitments, the PPA Parties have attempted to further reduce the risks of a full plant trip.

Amendment No. 6 memorializes KP's agreement to: (1) install equipment that will enable the fuel forwarding pump controls to ride through low voltage events for up to two (2) seconds in duration, and for a longer voltage disturbance, to stop the pumps from operating in order to prevent damage to the pump motors; and (2) take certain mitigation measures to minimize the risk of a full plant trip in the event of a lightning strike.

Amendment No. 6 also includes provisions that provide KP with substantial incentives to continue its aggressive, pro-active approach to minimizing the future risk of a full plant trip, including: (1) adding new definitions to identify full plant trips and correlate such trips to specific sequences of events; (2) liquidated damages in the event of a full plant trip; and (3) the reduction in capacity payments by HECO to KP. In addition, Amendment No. 6 sets forth specific agreed-upon criteria for circumstances under which the Facility should ride-through an under-voltage event.

Meanwhile: (1) Amendment No. 5 sets forth the PPA Parties' agreement that the calculation of the EAF will be based on a firm capacity of 189 MW; and (2) Amendment No. 6 codifies another agreed-upon measure of reliability, the on-peak equivalent forced outage rate (the "on-peak EFOR"), which applies to all of the Facility's firm capacity.²¹ Liquidated damage payments, if triggered, will also apply.

D.

Capacity Evaluation Protocol

Under the steam sales contract, KP is obligated to export a minimum level of process steam to Tesoro, while simultaneously supplying HECO with firm capacity and energy. KP must meet the process steam requirements set forth in its steam sales contract with Tesoro to enable the Facility to meet the status of a Qualifying Facility.

KP's ability to supply the additional 9 MW of firm capacity, as noted by HECO, already exists. The additional 20 MW of firm capacity set forth in Amendment No. 6, however, cannot be confirmed until the M Upgrade is completed.

Amendments No. 5 and No. 6, therefore, incorporate the PPA Parties' evaluation protocol to: (1) determine if the

²¹HECO explains that the on-peak EFOR provision is intended to provide KP "a substantial incentive to avoid forced outages (particularly during on-peak periods) and/or to complete work on an existing forced outage off-peak periods, in order to maximize the Facility's availability to HECO during the on-peak period (7:00 AM to 9:00 PM) when HECO most needs the maximum output from the Facility." HECO's Application, at 32. See also Sections 6 and 7 of Amendment No. 6.

Facility, prior to the M Upgrade, is able to meet all or part of the 9 MW increase in firm capacity; and (2) demonstrate the Facility's ability to provide additional firm capacity of up to 209 MW, following the implementation of the M Upgrade.

The evaluation protocol for the additional 9 MW is already completed and confirmed, and the PPA Parties agree that the Facility demonstrated a firm capacity capability of 189 MW. This conclusion is incorporated in Amendment No. 5.

Meanwhile, the PPA Parties' completion and confirmation of the evaluation protocol for the additional 20 MW, as set forth in Amendment No. 6 (the "M Upgrade evaluation protocol"), is pending.

E.

Financial Accounting

Amendment No. 5 includes provisions that enable HECO and its parent entity to address certain financial accounting matters relating to consolidation accounting and lease accounting, respectively, that may occur as a result of amending the Amended PPA.

1.

Consolidation Accounting

In December 2003, the Financial Accounting Standards Board ("FASB") issued its revised Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46R"). Exhibit C of the Application discusses in detail FIN 46R.

In summary, based on HECO's interpretation of FIN 46R, HECO reasons:

i. HECO, as a purchaser under a power purchase agreement, may be required to consolidate its certified financial statements with KP's financial statements.

ii. Thus, any new power purchase agreements or amendments to existing agreements with HECO should include a financial compliance provision that requires the independent power producer to supply information to HECO in order to comply with FIN 46R.

iii. If it is determined that HECO must consolidate KP's financial statements, HECO "must also assess the adequacy of [KP's] internal controls over financial reporting in order to comply with Section 404 of the Sarbanes-Oxley Act of 2002. ('SOX 404')." ²²

iv. "As it has not been determined that HECO does need to consolidate [KP], HECO has not determined what specific information would be required to comply with its assessment of internal controls to comply with SOX 404." ²³

Presently, HECO does not have the necessary information to ascertain whether consolidation under FIN 46R applies to the

²²HECO's Application, at 37, and Exhibit C, at 3 and 9. Section 404 of the Sarbanes-Oxley Act of 2002 provides that: (1) management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management shall assess the effectiveness of such internal control structure and procedures. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 789 (codified at 15 U.S.C. § 7262).

²³Exhibit C, at 9, of HECO's Application.

Amended PPA. Amendment No. 5, Section 23.20, thus, incorporates a financial compliance provision that sets forth procedures that permit HECO and its parent, Hawaiian Electric Industries ("HEI"), to comply with FIN 46R and SOX 404.

2.

Lease Accounting

In May 2003, the Emerging Issues Task Force ("EITF") of FASB issued its Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" ("EITF 01-8"). Exhibit C of the Application includes a detailed evaluation of whether the Amended PPA contains a lease.

EITF 01-8 specifies:

1. The tests to be applied in determining whether an arrangement (in this case, the Amended PPA) contains a lease; and
2. The circumstances under which an arrangement should be evaluated to determine whether it contains a lease.

HECO explains that, in general:

1. Under a transition provision, EITF 01-8 applies to HECO with respect to arrangements agreed to after, or modified after, June 30, 2003. Thus, with Amendments No. 5 and No. 6, it must address the potential application of EITF 01-8 to the Amended PPA.

2. The Amended PPA, if deemed a lease, will be classified as either an operating or capital lease. Thus, if the Amended PPA is classified as an operating lease, HECO will account for payments as expenses and KP will report the

investment in assets, related depreciation expenses, and lease revenue. Conversely, if it is classified as a capital lease, HECO will report an investment in asset, related depreciation, a capital lease obligation, and related interest expense. The Amended PPA's classification as a capital lease, therefore, could have a significant impact on HECO's financial statement reporting.

3. One (1) of the factors supporting the conclusion that the Amended PPA does not contain a lease is if the thermal output provided by KP to third-party Tesoro Hawaii Corporation is "more than a minor amount of the output taken by the third-party" under EITF 01-8, i.e., more than ten (10) per cent.

Accordingly, Article XXIV of Amendment No. 5 incorporates: (1) a minimum thermal threshold, set at twelve (12) per cent, with the option of increasing it to fifteen (15) per cent if an increase is deemed necessary so that the Amended PPA is not treated as a lease; and (2) a liquidated damages provision that strongly encourages KP to meet the minimum thermal threshold.

V.

HECO's Request

HECO seeks a commission decision that approves Amendments No. 5 and No. 6, and finds that:

1. The purchased power costs to be incurred by HECO as a result of Amendments No. 5 and No. 6 are reasonable.

2. HECO's purchase power arrangements under Amendments No. 5 and No. 6, pursuant to which HECO will purchase additional capacity from KP and may purchase additional energy, are prudent and in the public interest.

3. The fuel component and the additive component of the purchased energy costs and related revenue taxes to be incurred by HECO pursuant to Amendments No. 5 and No. 6, may be included in HECO's energy cost adjustment clause ("ECAC"), to the extent such costs are not included in its base rates.

4. HECO may include the costs of the additional capacity and the purchased power incurred by HECO pursuant to Amendments No. 5 and No. 6, in its revenue requirements for ratemaking purposes and for the purposes of determining the reasonableness of HECO's rates.²⁴

VI.

HECO's Position

In support of its Application, HECO asserts:

1. The availability of the additional 9 MW contemplated by Section 5.2(B)(2) of the Amended PPA, and KP's decision to implement the M Upgrade, provide HECO the opportunity to acquire up to 29 MW of additional firm capacity. This

²⁴In addition, with respect to the PPA Parties' settlement of the additive component of the energy charge, as set forth in Section 3 of Amendment No. 5 (the "additive component settlement"), HECO requests that the commission approve the additive component settlement as part of approving Amendment No. 5. Conversely, HECO requests that the commission declare that the change in the calculation of the additive component of the energy charge pursuant to the additive component settlement does not require the commission's approval.

additional capacity is consistent with the need, on Oahu, for 60 MW or more of additional capacity or load reduction measures, or both, in 2005, as identified in HECO's AOS Report.²⁵

2. Its Action Plan for increasing capacity and reliability, as identified in its AOS Report, states:

Negotiate increased availability provisions in the HECO and [KP] Amendments Nos. 5 and 6 with more defined terms of full plant trips and stiffer financial penalties for failing to meet availability requirements.²⁶

3. "The opportunity to acquire additional firm capacity at this particular Facility is attractive because the Facility has a good reliability record, 9 MW of firm capacity already exists, the addition of up to 20 MW of firm capacity will be made available through mechanical efficiency upgrades of an existing facility, and the potential delays and uncertainty associated with permitting and construct[ing] new capacity can be avoided."²⁷

4. The new increment of up to 29 MW in capacity is priced at \$112 per kW-year as compared to the capacity rate of \$164.35 per kW-year for the existing 180 MW of capacity.

²⁵This 60 MW sum is in addition to the: (1) projected successful implementation of the commission-approved HECO residential and commercial load management demand-side management ("DSM") programs; (2) projected commission approval and successful implementation of enhanced energy efficiency DSM programs beginning in July 2005; and (3) availability of up to 29 MW of additional firm capacity from KP in 2005, following the commission's approval of HECO's Application. See HECO's AOS Report (HECO's references to Amendments No. 5 and No. 6).

²⁶HECO's AOS Report, at 25, Section 5.4.

²⁷HECO's Application, at 10. See also HECO's response to CA-IR-44.

5. The avoided cost calculated to evaluate the attractiveness of KP's \$112 per kW-year rate is understated. HECO performed an avoided capacity analysis based on the proxy method using a nominal 112 MW simple cycle CT with a commercial operation of 2009 as the proxy unit. In actuality, the capacity is needed now and the use of a proxy unit installed in 2005 would have produced a higher avoided capacity cost.

Moreover, "avoided energy savings would . . . need to be credited because the contract energy price of [KP] is significantly lower than the energy price of the proxy simple cycle [CT] and this avoided energy costs were not included in HECO's calculation of avoided costs."²⁸

6. The capacity increases are expected to be achieved by KP without any additional fuel consumption on a per kWh basis, meaning that less fuel will be needed for the same energy output. Under Amendments No. 5 and No. 6, KP will have a firm commitment to make the capacity available, and a portion of the energy purchased by HECO will be at a lower price. Thus, KP will pass on a portion of the efficiency savings.

HECO and its ratepayers will benefit to the extent the:

- (A) additional purchased energy could cost HECO less than it would have cost HECO to generate the energy itself; and
- (B) availability of the additional energy improves HECO's reliability.

7. The increase in capacity and energy will come from an existing facility that does not require new investment in

²⁸HECO's response to CA-IR-11(a).

another plant or the transmission and substation infrastructure normally required for a new plant site that is designed to produce up to 29 MW.

8. HECO performed an Interconnection Requirements Study ("IRS"), paid for by KP, to assess the potential impact on the interconnection facilities of increasing the Facility's output through the M Upgrade. The IRS concluded that "the existing [i]nterconnection [f]acilities could accommodate the increased electrical output and also that HECO is required to adjust the settings on some fault detectors that supervise certain distance relays that are located in two HECO substations."²⁹

9. The "GNPIPD [index] was chosen because it is a common and well-established index already used within the Amended PPA, and because of the lack of any other more suitable alternative that would reflect the inflation in the costs of the fuel additive material, labor in producing the additive mix and transportation to the plant site."³⁰

10. With respect to HECO's Integrated Resource Plan ("IRP"), Amendments No. 5 and No. 6: (A) are consistent with HECO's 2nd IRP, taking into account current circumstances, and will be included in HECO's 3rd IRP; (B) provide for additional

²⁹HECO's Application, at 47. KP agrees to pay for the costs of these adjustments, estimated at \$4,500, pursuant to Section 5 of Amendment No. 6.

³⁰HECO's Application, at 19 (footnote and text therein omitted). See also HECO's response to CA-IR-17 (a qualitative analysis was performed in determining the reasonableness of using the GNPIPD to adjust the base additive component).

firm capacity from an existing independent power production facility, "which will help to avoid accelerating the need date for the next central station generating unit in HECO's 2nd IRP[;]" and (C) are consistent with and should further HECO's IRP objectives, in particular, Sections 5.5 (achieving dependable statewide energy systems) and 5.6 (maintaining reliability) of HECO's 2nd IRP.

VII.

Consumer Advocate's Position

The Consumer Advocate focused its review on: (1) HECO's need for the additional generation; (2) the rates under the amended terms; (3) the environmental impact of the Facility upgrades; (4) performance guarantees; (5) the additive component settlement; (6) consolidation accounting; and (7) HECO's Integrated Resource Plan-3 ("IRP-3").

A.

Need for Additional Generation

The Consumer Advocate finds that HECO's data and information appears to confirm that HECO has a substantial resource deficiency, as stated in its AOS Report. Without the additional capacity provided by KP to HECO under Amendments No. 5 and No. 6, HECO's need for additional generating capacity will approach ninety (90) MW in 2005. Conversely, even if the commission approves both amendments, HECO's capacity shortfall

will range between fifty (50) MW and seventy (70) MW through 2009.

The Consumer Advocate, thus, solely for the purpose of assessing the merits of both amendments, accepts HECO's claim that there is a need for additional capacity that KP will provide under the terms of Amendments No. 5 and No. 6.

B.

Rates

The Consumer Advocate notes that:

1. Under the Amended PPA HECO currently pays \$164.35 per kW-year for the first 180 MW of firm capacity, and under the Amended PPA, HECO will pay \$112 per kW-year for the additional capacity increments of 9 MW and up to 20 MW, respectively.

2. HECO states that the \$112 per kW-year price: (1) compares favorably with the \$126 per kW-year price that resulted from its proxy unit method for determining a price for incremental capacity; and (2) also compares favorably with the price for the initial 180 MW capacity increment, which the Consumer Advocate notes resulted from a competitive bidding process (though now outdated).

3. HECO used its production cost model to evaluate the proposed prices under both amendments. HECO's simulation finds that KP's incremental 29 MW of additional capacity "would be cost effective *vis-à-vis* other units" on HECO's system.³¹

³¹Consumer Advocate's position statement, at 12.

4. The pricing terms of Amendments No. 5 and No. 6 are acceptable, "when simply compar[ing] the price to the existing contract terms."³² HECO did not, however, evaluate and compare the cost-effectiveness of this resource addition with other, alternative purchase options to HECO's resource base that could have been available during the remaining term of the existing Amended PPA.³³ HECO reasons that the incremental 29 MW of additional capacity is the only feasible option at this time.

5. "HECO appears to be in immediate need of additional generating capacity. Thus, within this context, the Consumer Advocate finds acceptable the price terms of Amendments 5 and 6."³⁴

Nonetheless, the Consumer Advocate expresses its concerns with HECO's resource planning, noting:

Where unforeseen near-term needs occur, [HECO] should be expected to: (1) make every effort to identify the full range of resources with the potential to address those needs (which may include the use of competitive solicitation processes); and (2) evaluate the cost-effectiveness of all such resource options using techniques that consider both the short- and long-term economics. These are among the fundamental principles of least-cost planning.³⁵

³²Id.

³³The Consumer Advocate specifically notes that HECO's production simulation model "was constrained in that it did not incorporate any other potential new additions to HECO's resource base - these include facilities that might have displaced the output of the 29 MW [KP] increment and that could be developed before Amendments 5 and 6 expire with the rest of the contract in 2016." Id. at 13.

³⁴Id. at 13 - 14.

³⁵Id. at 14.

C.

Environmental Impacts

The Consumer Advocate, in its review of the environmental impacts of KP's capacity upgrades, finds that:

1. The 9 MW upgrade is already anticipated by the PPA Parties in the existing Amended PPA, pursuant to established contract terms.

2. The 20 MW capacity upgrade pursuant to Amendment No. 6 will be achieved through redesigned power plant components, thereby improving the Facility's efficiency such that the Facility is able to produce an additional 20 MWs of capacity and associated energy while burning the same total quantity of fuel as before.

3. "Because Amendments 5 and 6 would bring additional firm capacity with no change to the level of fuel consumption vis-à-vis the existing Amended PPA, this resource addition would not bring the environmental impacts that might be considered typical of other generating capacity additions. . . . Therefore, the Consumer Advocate views Amendments 5 and 6 to the [KP] agreements as an environmentally benign resource addition, relative to most other supply-side resource options."³⁶

D.

Performance Guarantees

The Consumer Advocate notes that: (1) at 209 MWs, KP's Facility will be the largest independent facility on HECO's

³⁶Id. at 15.

system; accordingly (2) Amendments No. 5 and No. 6 introduce various terms, such as liquidated damages, that are intended to create incentives for KP to: (A) maximize the availability of its Facility output during peak load conditions; and (B) minimize the potential for full plant trips. "The Consumer Advocate views these various actions as reasonable ways to mitigate the risks and cost impacts of full-plant trips at Kalaeloa, and to increase the [F]acility's on-peak availability."³⁷

E.

Additive Component Settlement

The Consumer Advocate notes that the Bureau's discontinuance of the Magnesium PPI precipitated a dispute between the PPA Parties regarding the pricing of the additive component.³⁸ Amendment No. 5 provides that: (1) as part of the PPA Parties' settlement of the additive component issue, HECO will be credited with a full refund of \$555,530, beginning in January 2004, associated with additive component payments during the twelve (12) months of 2003; and (2) a new approach and index will be used, beginning in January 2004, for pricing the fuel additive.

The Consumer Advocate finds that the PPA Parties' resolution represents a reasonable compromise of the additive component issue.

³⁷Id. at 17.

³⁸See footnote 16, above.

F.

Consolidation Accounting

For consolidation accounting, HECO claims that a consolidation of HECO's and KP's financial statements may result in HECO being required to report KP's debt and equity as HECO's, which HECO asserts will have the potential of altering HECO's capital structure relative to target levels.³⁹ Specifically, if consolidation under FIN 46R is necessary, HECO expects KP to be considerably more leveraged than HECO. Thus, if HECO determines that it is necessary to maintain its current target equity ratio, it estimates that it will need to retire approximately \$65 million in existing debt and infuse matching amounts of equity, thereby increasing HECO's annual revenue requirements by approximately \$2 million to \$9 million.

The Consumer Advocate reasons that: (1) the \$9 million cost impact could nearly double the costs of acquiring the additional 29 MW in capacity from KP; and (2) in the absence of any rebalancing of HECO's capital structure, the amendments will represent an incremental purchase at a cost that is approximately \$2.3 million below HECO's avoided cost. Conversely, if a rebalancing of HECO's capital structure occurs, the cost of the additional resource acquisition will considerably exceed HECO's avoided costs.

Nonetheless, the Consumer Advocate emphasizes that it is unsettled as to: (1) whether the consolidation of HECO's and

³⁹See HECO's Application, Section X(A)(4), Impact of Consolidation Accounting Treatment on Credit Quality.

KP's financial statements is necessary; and if so (2) the likelihood and magnitude of HECO incurring such FIN 46R-related costs. In any event, the Consumer Advocate contends that:

1. A determination should not be made in this proceeding as to whether ratepayers are required to pay for these potentially unsubstantiated costs.

2. Instead, the issue is more appropriate for resolution in another docket, specifically, in a rate case application or an application seeking the commission's approval to retire debt and issue equity under HRS § 269-17, as HECO claims.⁴⁰

3. Thus, if the commission approves Amendments No. 5 and No. 6: (A) the commission should not determine in this proceeding whether ratepayers are responsible for HECO's unsubstantiated accounting risks under FIN 46R; and instead (B) should establish that such a determination should be made in a rate case application or an application filed pursuant to HRS § 269-17.

G.

HECO's IRP-3

The Consumer Advocate states that HECO's IRP-3 does not mention or anticipate the additional 29 MW of capacity from KP. Nonetheless, this acquisition of 29 MW of additional capacity meets the Consumer Advocate's two (2)-part test governing

⁴⁰The Consumer Advocate, at different times, refers to HECO's pending rate case application, and conversely, to a future rate case application.

resource acquisitions between IRP cycles: (1) the amendments promise to bring significant benefits to ratepayers by delivering needed capacity at an acceptable price (assuming that a ruling is not made in this proceeding that ratepayers are responsible for HECO's claimed substantial accounting risks associated with the amendments); and (2) precisely because HECO's need for additional capacity is substantial and immediate, Amendments No. 5 and No. 6 should not be delayed.

H.

Conclusion

The Consumer Advocate concludes by stating its non-objection to the commission's approval of HECO's Application, provided that the commission adopts the recommended condition that the commission: (1) refrain from deciding in this proceeding whether ratepayers are responsible for HECO's unsubstantiated accounting risks under FIN 46R; and instead (2) state that such a decision be made in a rate case application or an application filed pursuant to HRS § 269-17.

VIII.

Commission's Review

A.

Rates for Purchase

In general, HAR chapter 6-74, subchapter 3, guides the commission's review of the rates agreed upon between HECO and KP.

HAR § 6-74-22(a) of chapter 6-74, subchapter 3, provides that the rates for purchase shall:

1. Be just and reasonable to the electric consumer of the electric utility and in the public interest;
2. Not discriminate against qualifying cogeneration and small power production facilities; and
3. Be not less than one hundred (100) per cent of avoided cost for energy and capacity purchases to be determined as provided in HAR § 6-74-23 from qualifying facilities and not less than the minimum purchase rate.

Nonetheless, notwithstanding HAR § 6-74-22, nothing in HAR chapter 6-74, subchapter 3, prohibits an electric utility or any qualifying facility from agreeing to a rate for purchase, or terms or conditions relating to any purchase, which differ from the rates, terms, or conditions that would otherwise be required by subchapter 3. HAR § 6-74-15(b)(1).

The capacity charge of \$112 per kW-year under Amendment No. 5 memorializes the PPA Parties' agreement pursuant to Section 5.2(B)(2) of the Amended PPA (the excess capacity charge).⁴¹ In addition, the capacity charge of \$112 per kW-year under both amendments is lower than the capacity rate of \$164.35 per kW-year for the existing 180 MW of capacity.

The Incentive Energy provision under which the variable O&M component will replace the non-fuel component of the energy charge once the minimum energy purchase obligation is met in a given contract year, is designed to lower HECO's energy payments,

⁴¹The commission approved the PPA that incorporates the \$112 per kW-year excess capacity rate set forth in Section 5.2(B)(2). See Decision and Order No. 10369, filed on October 16, 1989, in Docket No. 6378.

for the ratepayers' benefit. Meanwhile, the PPA Parties' proposed use of the GNPIPD replacement index in calculating the additive component is the same index already used to adjust the non-fuel component for inflation.⁴²

The commission, like the Consumer Advocate, finds the pricing terms under Amendments No. 5 and No. 6 acceptable.

B.

Consumer Advocate's Recommended Condition

HECO states that presently, it does not have the necessary information to ascertain whether consolidation under FIN 46R applies to the Amended PPA. Thus, Section 23.20 of Amendment No. 5 incorporates a financial compliance provision that set forth procedures that permit HECO and HEI to comply with FIN 46R and SOX 404.

The Consumer Advocate counters that if the commission approves Amendments No. 5 and No. 6: (1) the commission should refrain from deciding in this proceeding whether ratepayers are responsible for HECO's unsubstantiated accounting risks under FIN 46R; and instead (2) should establish that such a decision be made in a rate case application or an application filed pursuant to HRS § 269-17.

HECO responds that: (1) Amendment No. 5 provides HECO with the opportunity to meet its obligations under the applicable accounting guidelines to acquire the information from KP

⁴²The commission notes that in Amendment No. 5, Section 4(A), the phrase "GNPIPD(base)" should replace "GNIPID(base)".

necessary to comply with FIN 46R and related authoritative guidance; and (2) as noted by the Consumer Advocate, "no determination has been or can be made at this time as to whether HECO will have to consolidate [KP] for financial statement purposes, whether such consolidation would affect HECO's credit rating, and/or whether it would be prudent for HECO to 'rebalance' its capitalization as a result."⁴³ Thus, HECO concurs with the Consumer Advocate that it is premature for the commission to determine, at this time, whether rebalancing is prudent.⁴⁴

HECO and KP agree to Section 23.20, as part of Amendment No. 5. Under Section 23.20, KP agrees to provide HECO with certain financial information to allow HECO to determine whether the consolidation of HECO's and KP's financial statements is required. Without Section 23.20, KP is under no obligation to provide HECO with KP's financial information.

Section 23.20, moreover, is substantially similar to the consolidation accounting provisions previously approved by the commission for as-available power purchase contracts between: (1) HECO and Apollo Energy Corporation (Docket No. 04-0346); and (2) Maui Electric Company, Limited and Kaheawa Wind Power (Docket No. 04-0365).

⁴³HECO's letter, dated April 29, 2005, at 1.

⁴⁴HECO concludes: "If, however, HECO does 'rebalance' at some time in the future, and the Commission finds at such time that rebalancing was prudent, then HECO would except the impact of rebalancing, if any, on HECO's cost of capital to be taken into account in future rate proceedings." Id. at 2 (underscore in original).

The commission finds that Section 23.20, which memorializes certain *procedures* upon which KP agrees to provide its financial information to HECO, is reasonable. Concomitantly, the *consequence* that may arise out of HECO's review of KP's financial information, is speculative and premature, and more notably, beyond the scope of this proceeding. Until HECO receives and reviews KP's financial information, HECO states that it is unable to ascertain whether consolidation is necessary under FIN 46R. Moreover, following HECO's review of KP's financial information, HECO may very well conclude that consolidation is not necessary.

C.

Level of Additional Capacity

The M Upgrade evaluation protocol sets forth a protocol to demonstrate KP's ability, following the implementation of the M Upgrade, to provide additional capacity of up to 209 MW to HECO. The results of the M Upgrade evaluation protocol have not been filed in this docket. While the PPA Parties anticipate that the Facility will be able to provide an additional 20 MW of capacity over the 189 MW amount, the Facility's *actual* level of capacity must be established by the results of the M Upgrade evaluation protocol. As such, the Facility's *actual* level of capacity is not known at this time.

While the commission is able to conclude that it is reasonable to allow HECO to include the costs of the additional capacity in HECO's revenue requirements for ratemaking purposes,

the appropriate level of additional capacity under Amendments No. 5 and No. 6 used in setting HECO's revenue requirement, is deferred to HECO's pending rate case (Docket No. 04-0113, 2005 calendar test year).⁴⁵

As part of this review, HECO must submit copies of the results of the M Upgrade evaluation protocol.

D.

Ultimate Findings and Conclusions

HECO states that an immediate need exists for firm capacity, and the additional capacity from KP is available now, provided the commission approves HECO's Application. HECO's need for additional firm capacity, moreover, is verified by its AOS Report. The Consumer Advocate concurs that a need for additional generating capacity exists. HECO intends to continue to dispatch the Facility as a baseload plant, at or near the 209 MW level, primarily during the on-peak periods.

The commission makes the following findings and conclusions:

⁴⁵KP's steam sales contract is not part of the docket record. Nonetheless, it appears that KP is obligated to export 121,000 lb/hr of processed steam to Tesoro. See HECO's Application, at 33 (the level of 121,000 lb/hr projected in the steam sales contract) and 36 (the nominal 121,000 lb/hr level in the steam sales contract); HECO's Verification; Amendment No. 5, Section 4(B)(1)(A) (121,000 lb/hr of process steam); and HECO's response to CA-IR-2 at 2 (121,000 lb/hr). Presently, it is uncertain as to whether KP is able to supply to HECO the firm capacity to be established by the M Upgrade evaluation protocol, while simultaneously meeting its process steam obligations under the steam sales contract to Tesoro.

1. The purchased power costs to be incurred by HECO as a result of Amendments No. 5 and No. 6, are reasonable.

2. HECO's purchase power arrangements under Amendments No. 5 and No. 6, pursuant to which HECO will purchase additional capacity from KP and may purchase additional energy, are prudent and in the public interest.

3. The fuel component and additive component of the purchased energy costs and related revenue taxes to be incurred by HECO pursuant to Amendments No. 5 and No. 6, may be included in HECO's ECAC, to the extent such costs are not included in its base rates.⁴⁶

4. HECO may include the costs of the additional capacity and the purchased power incurred by HECO pursuant to Amendments No. 5 and No. 6, in its revenue requirements for ratemaking purposes and for the purposes of determining the reasonableness of HECO's rates.

In sum, the commission approves Amendments No. 5 and No. 6.⁴⁷

⁴⁶This action is consistent with Decision and Order No. 10824, filed on October 31, 1990, wherein the commission found it "reasonable for HECO to pass on to its ratepayers the fuel component, including the fuel additive component, of the energy charge through HECO's fuel adjustment clause." *Id.* at 26; see also id. at 27, Ordering Paragraph No. 2.

⁴⁷The commission's approval of Amendment No. 5 renders moot the need to separately approve the PPA Parties' settlement of the additive component issue, as set forth in Section 3 of Amendment No. 5.

IX.

Orders

THE COMMISSION ORDERS:

1. Amendments No. 5 and No. 6 between HECO and KP, both dated October 12, 2004, are approved.
2. The purchased power costs to be incurred by HECO as a result of Amendments No. 5 and No. 6 are reasonable.
3. HECO's purchase power arrangements under Amendments No. 5 and No. 6, pursuant to which HECO will purchase additional capacity from KP and may purchase additional energy, are prudent and in the public interest.
4. The fuel component and the additive component of the purchased energy costs and related revenue taxes to be incurred by HECO pursuant to Amendments No. 5 and No. 6, may be included in HECO's ECAC, to the extent such costs are not included in its base rates.
5. HECO may include the costs of the additional capacity and the purchased power incurred by HECO pursuant to Amendments No. 5 and No. 6, in its revenue requirements for ratemaking purposes and for the purposes of determining the reasonableness of HECO's rates.
6. The consequence that may arise out of HECO's review of KP's financial information is beyond the scope of this proceeding.
7. Any decision as to the appropriate level of additional capacity under Amendments No. 5 and No. 6 used in

setting HECO's revenue requirement, is deferred to HECO's pending 2005 calendar test year rate case (Docket No. 04-0113).

8. HECO shall submit copies of the results of the M Upgrade evaluation protocol to the commission and Consumer Advocate, within thirty (30) days following its completion.

DONE at Honolulu, Hawaii MAY 12 2005.

PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

By Carlito P. Caliboso
Carlito P. Caliboso, Chairman

By Wayne H. Kimura
Wayne H. Kimura, Commissioner

By Janet E. Kawelo
Janet E. Kawelo, Commissioner

APPROVED AS TO FORM:

Michael Azama
Michael Azama
Commission Counsel

04-0320.cs

CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing Decision and Order No. 21820 upon the following parties, by causing a copy hereof to be mailed, postage prepaid, and properly addressed to each such party.

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