

BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF HAWAII

In the Matter of the Application of)

MAUI ELECTRIC COMPANY, LIMITED )

DOCKET NO. 2006-0186

For Approval of a Combined Heat and)  
Power Agreement with Castle & Cooke)  
Resorts, LLC, and Approval to )  
Include the Combined Heat and Power)  
System Fuel Costs in Maui Electric )  
Company, Limited's Energy Cost )  
Adjustment Clause. )

DECISION AND ORDER NO. 24058

Filed Feb. 28, 2008

At 11 o'clock A.M.

Karen Higashi

Chief Clerk of the Commission

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Commission, State of Hawaii

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Decision and Order No. 24058

By this Decision and Order, the commission approves the Combined Heat and Power ("CHP") Agreement, dated June 16, 2006 (the "CHP Agreement"), between MAUI ELECTRIC COMPANY, LIMITED ("MECO") and Castle & Cooke Resorts, LLC ("C&C Resorts"), and other related matters, arising out of the Application filed by MECO on July 14, 2006.<sup>1</sup> In doing so, the commission approves the Stipulation Regarding Hearing and Commission Approval jointly filed by MECO, and the DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS, DIVISION OF CONSUMER ADVOCACY ("Consumer Advocate"),

<sup>1</sup>MECO's Application; Verification; Exhibits 1 - 3; and Certificate of Service, filed on July 14, 2006 (collectively, "Application").

on November 9, 2007;<sup>2</sup> with the exception of the Parties' recommendation to open a generic proceeding to examine the issue of stranded costs.

I.

Background

A.

MECO and C&C Resorts

MECO is the franchised provider of electric utility service on the islands of Lanai, Maui, and Molokai. On Lanai, MECO produces electricity at the Miki Basin Generating Station, i.e., its primary generating units.

C&C Resorts is a Hawaii limited liability company that primarily does business on Lanai. C&C Resorts is the owner of the Four Seasons Resort Lanai at Manele Bay Hotel ("Hotel"), Lodge at Koele, and its Central Services Facility.

B.

Dockets No. 03-0261 and No. 03-0371

On February 24, 2004, the commission, in In re Maui Elec. Co., Ltd., Docket No. 03-0261, approved, subject to

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<sup>2</sup>Stipulation Regarding Hearing and Commission Approval; Exhibit A (filed under partial confidential seal); and Certificate of Service, filed on November 9, 2007 (collectively, "Stipulation").

The Parties are MECO and the Consumer Advocate, an ex officio party to this proceeding, pursuant to Hawaii Revised Statutes ("HRS") § 269-51 and Hawaii Administrative Rules ("HAR") § 6-61-62(a).



one revision, a service contract between MECO and C&C Resorts, dated August 20, 2003 ("Service Contract").<sup>3</sup>

On January 27, 2006, the commission, in In re Public Util. Comm'n, Docket No. 03-0371, issued Decision and Order No. 22248, "set[ting] forth certain policies and principles for the development of distributed generation in Hawaii and certain guidelines and requirements for distributed generation, some of which will be further defined by tariff as approved by

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<sup>3</sup>See In re Maui Elec. Co., Ltd., Docket No. 03-0261, Decision and Order No. 20811, filed on February 24, 2004. The Service Contract consists of three parts: (1) a \$250,000 annual discount for electric utility service to the Hotel for three years, scheduled to expire on February 24, 2007; (2) an arrangement to implement ten energy conservation measures; and (3) consideration of a MECO-owned CHP facility at the Hotel with a new rate for energy supplied by the CHP System that results in a lower electric bill than MECO's current rates. C&C Resorts is not obligated to undertake the CHP project with MECO, and instead, could choose to undertake a similar CHP project with a third-party.

The commission found reasonable and consistent with the public interest the first two parts of the Service Contract. Id. at 3-7. Concomitantly, the commission made no ruling with respect to the reasonableness of the third part of the Service Contract, i.e., MECO's proposed CHP project:

The third part of the service contract is that . . . MECO and C&C Resorts will pursue the possible installation of a MECO-owned CHP facility at the Manele Bay Hotel, including providing energy at a lower rate for C&C Resorts than the rate charged other customers in the same customer class. MECO states that it will seek commission approval of its CHP agreement with C&C Resorts under a separate application. MECO also states that no negotiations have begun regarding the possible CHP facility and that C&C Resorts is not obligated to install MECO's proposed CHP project at the Manele Bay Hotel site. Therefore, the commission finds that it need not make a determination as to the reasonableness of MECO's proposed CHP project at this time and further notes that the commission has not ruled on . . . [its] own investigation into distributed generation in Hawaii, Docket No. 03-0371.

Id. at 7-8 (emphasis added).

the commission."<sup>4</sup> In Section II.B of Decision and Order No. 22248, relating to the ownership of distributed generation ("DG"), the commission concluded in part:

If the utility wishes to sell distributed generation services as a regulated utility, the utility must show, in an application filed with the commission, the following:

- (a) the distributed generation resolves a legitimate system need;
- (b) the distributed generation proposed by the utility is the least cost alternative to meet that need; and
- (c) in an open and competitive process acceptable to the commission, the customer-generator was unable to find another entity ready and able to supply the proposed distributed generation service at a price and quality comparable to the utility's offering.

The commission may establish further detailed guidelines on the foregoing application requirements by rule or order, if circumstances indicate that these requirements are insufficient to achieve the goals described in this Decision and Order.

By establishing the preceding conditions to utility participation in the distributed generation market, the commission seeks to allow utility participation to address immediate system needs when required in a manner that minimizes the possibility that utility participation will impede entry of new competitors in the immediate and longer term.

In re Public Util. Comm'n, Docket No. 03-0371, Decision and Order No. 22248, at 22 - 23 (emphasis added); see also id. at 20 and 46, Ordering Paragraph No. 2.

<sup>4</sup>In re Public Util. Comm'n, Docket No. 03-0371, Decision and Order No. 22248, filed on January 27, 2006, at 1. The parties in Docket No. 03-0371 included all of the electric utilities that operate within the State of Hawaii: Hawaiian Electric Co., Inc., Hawaii Electric Light Co., Inc., MECO (collectively, the "HECO Companies"), and Kauai Island Utility Cooperative.

On April 6, 2006, the commission, in Docket No. 03-0371: (1) granted in part and denied in part the motion for clarification filed by the HECO Companies; and (2) denied the HECO Companies' motion for partial reconsideration.<sup>5</sup> The HECO Companies, as part of their motion, sought clarification that requirement (c) would not retroactively apply to the MECO-owned CHP facility being considered for C&C Resorts' Hotel. The commission, in response, held that the HECO Companies' request was premature:

The commission recognizes that the distributed generation project being considered on Lanai has not yet been proposed to, and approved by, the commission.

It would be premature to determine that Decision and Order No. 22248 does not apply to the distributed generation projects being considered, but not yet approved, on Lanai. This issue has not been adequately briefed by the parties involved. Any such determination should be based on the specific facts supporting the proposed project, with the burden on the utility to justify its request.

In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, at 20. In addition, the commission clarified that under requirement (b), the term "least cost" meant "lowest reasonable cost."<sup>6</sup>

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<sup>5</sup>In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, filed on April 6, 2006.

<sup>6</sup>In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, at 12-14.

C.

Application

On July 14, 2006, MECO filed its Application requesting the commission's approval of the CHP Agreement between MECO and C&C Resorts governing the installation and operation of a CHP system at the Hotel ("CHP System").<sup>7</sup>

The CHP System: (1) is a distributed generation unit designed to produce both electricity and thermal energy; (2) will include a single nominal 819 kilowatt ("kW") CHP unit, a 115-ton absorption chiller, hot water heat exchangers, an above-ground diesel fuel storage tank (10,000 gallon capacity), and other related equipment, installed on-site at the Hotel; (3) will be interconnected with MECO's Lanai Division's grid ("MECO's grid"); and (4) will be procured from Hawthorne Pacific, the Hawaii-based distributor of Caterpillar diesel engine generating equipment.<sup>8</sup> C&C Resorts will provide adequate space for the installation of the CHP System by MECO, at no cost to MECO, under a license granted to MECO by C&C Resorts.<sup>9</sup> The CHP System controls are designed for unattended operation with remote monitoring and control.<sup>10</sup>

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<sup>7</sup>MECO's Application, Exhibit 1, the CHP Agreement.

<sup>8</sup>MECO's Application, at 5-9. CHP Agreement, Section 4.2, at 4, and Appendix A. According to MECO, "a Caterpillar engine-based CHP system [will] be smoothly integrated into MECO's Lanai Division operations and maintenance practices." MECO's Application, at 8.

<sup>9</sup>CHP Agreement, Section 4.2, at 4-5.

<sup>10</sup>MECO's Application, at 8.

MECO will design, construct, install, own, operate, and maintain the CHP System, which will utilize diesel fuel.<sup>11</sup> Specifically, MECO will: (1) design the CHP System to ensure that, in the event of any CHP System failure, the Hotel's electric system can automatically access power from MECO's grid; (2) provide CHP System operations and maintenance support for routine and emergency repairs and for the maintenance and operation of the system; and (3) purchase the diesel fuel needed to operate the CHP System from the Lanai Oil Company, Inc.<sup>12</sup>

C&C Resorts will purchase from MECO the electricity and thermal energy produced by the CHP System and used by the Hotel in accordance with the pricing formula set forth in Appendices B, C, and D of the CHP Agreement.<sup>13</sup> In general:

1. The price for all electricity delivered to the Hotel will be billed in accordance with the provisions of MECO's Schedule P rates, subject to the following modification: the energy rate component of Schedule P will be reduced by \$0.015 per kilowatt hours ("kWh") for each net kWh generated by

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<sup>11</sup>MECO's Application, at 8 and 14; and CHP Agreement, Sections 2.3, 3.3, 3.7 and 5.1, at 2, 4, and 7.

<sup>12</sup>MECO's Application, at 14 and 17-18. CHP Agreement, Sections 3.4, 3.5 and 4.8, at 3, 4, and 7.

<sup>13</sup>CHP Agreement, Section 4.8, at 7, and Appendices B, C, and D.

the CHP System.<sup>14</sup> A minimum annual discount will be available to the Hotel each year based upon the pre-established operating parameters for the CHP System and the Hotel's actual electricity consumption.<sup>15</sup>

2. The price for the thermal energy produced by the CHP System is filed under confidential seal.<sup>16</sup> C&C Resorts is required to purchase a minimum amount of thermal energy each year.

3. C&C Resorts shall also pay to MECO a fixed facilities fee of \$1,075 per month (\$2005) to cover the costs of the heat recovery equipment not included in MECO's normal electrical rate structure (i.e., the 115-ton absorption chiller and hot water heat exchangers).<sup>17</sup>

"The peak CHP System net capacity is 884 kW including the cogen[eration] unit output and absorption chiller load

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<sup>14</sup>See MECO's Application, at 15, and CHP Agreement, Appendix B, Electric Energy Pricing; see also MECO's response to CA-IR-3 (MECO primarily considered two factors in determining the \$0.015 kWh energy discount rate).

According to MECO, "[t]he \$0.015 per kWh energy rate discount rate was deemed appropriate for the Manele Bay CHP project when the estimated annual savings to C&C Resorts totaled approximately \$250,000, which is the amount of the annual electricity discount provided to C&C Resorts under the Service Contract." MECO's response to CA-IR-3 (referring to a table filed under confidential seal).

<sup>15</sup>See MECO's Application, at 15, and CHP Agreement, Appendix B, Electric Energy Pricing.

<sup>16</sup>MECO's responses to CA-IR-3 and CA-IR-5 (filed under partial confidential seal).

<sup>17</sup>See MECO's Application, Purchase and Sale of Electrical Power Output and Thermal Energy, at 15; the CHP Agreement, Sections 4.8 and 4.9, at 7, and Appendices B, C (confidential seal), and D; and MECO's response to CA-IR-4 (filed under partial confidential seal).

off-set, less auxiliary loads."<sup>18</sup> The 884 kW CHP System capacity was sized to match the Hotel's chilled water and domestic hot water loads, along with a majority of its electrical load.

MECO's procurement and construction of the CHP System will not commence until it receives the requisite regulatory approvals, including approval from the commission and approval from the State of Hawaii ("State"), Department of Health, for a covered source air permit.<sup>19</sup> For the CHP System: (1) the estimated in-service date is the end of 2007 (subsequently updated to January 2009); and (2) the project's estimated cost is \$2.1 million.<sup>20</sup>

The CHP Agreement will take effect upon MECO's receipt of a final decision and order from the commission that approves

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<sup>18</sup>CHP Agreement, Appendix A.

<sup>19</sup>MECO's Application, at 9-10.

<sup>20</sup>MECO's Application, at 9-10; and CHP Agreement, Appendix A, Schedule 1-A. According to MECO:

After the [CHP System] is deemed used and useful for ratemaking purposes, MECO will seek to include the capital CHP project's final costs in its rate base in its next general rate case proceeding. Included in the determination of revenue requirements in that proceeding will be a rate of return on rate base for the capital costs for the project. The revenue requirements will also include the depreciation expenses associated with the project, the test year estimate for the project's operations and maintenance expenses, and fuel costs for the project. Changes in fuel costs for the project will be recovered through MECO's Energy Cost Adjustment Clause.

MECO's response to CA-IR-2(b).

MECO's requested relief (if any).<sup>21</sup> If MECO does not receive the commission's approval within 120 days of the last signature to the CHP Agreement, i.e., by October 14, 2006, either party may terminate the agreement by proving written notice of termination to the other party prior to the effective date.<sup>22</sup> Either party also has the right to terminate the agreement under certain specified conditions.<sup>23</sup> In addition, the CHP Agreement includes cross-indemnification, limitation of liability, and insurance

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<sup>21</sup>MECO's Application, at 14; and CHP Agreement, Sections 1.2 and 5.3, at 1 and 7-8. The initial-term of the CHP Agreement is twenty years from the effective date, subject to automatic renewal for successive twelve-month periods if not affirmatively terminated by either party. MECO's Application, at 14; and CHP Agreement, Section 5.3, at 7-8.

<sup>22</sup>MECO's Application, at 14; and CHP Agreement, Section 1.2, at 1. MECO filed its Application on July 14, 2006. The date of the last signature on the CHP Agreement is June 16, 2006. CHP Agreement, at 13. Thus, MECO and C&C Resorts initially expected the commission to issue its final decision and order by October 14, 2006. See MECO's Application, at 14. Nonetheless, in the proposed Stipulated Prehearing Order submitted by the Parties on August 25, 2006 and ultimately approved by the commission, MECO effectively waived commission action by October 14, 2006. As noted by the commission in Order No. 22837, filed on September 11, 2006:

Lastly, the commission notes that MECO initially requested commission action on the merits of its Application by October 14, 2006. Now, however, the proposed Stipulated Prehearing Order includes five deadlines that occur after October 14, 2006, including the deadline for the Consumer Advocate and MECO to file their respective Statements of Position (January 18, 2007 and February 8, 2007, respectively). Thus, MECO effectively waives commission action by October 14, 2006.

Order No. 22837, at 4 (emphasis added).

<sup>23</sup>CHP Agreement, Section 5.4, 8-9.



provisions.<sup>24</sup> Moreover, the CHP Agreement "is at all times subject to changes and modifications as the PUC may direct from time to time in the exercise of its jurisdiction."<sup>25</sup>

In addition to commission approval of the CHP Agreement, MECO seeks in its Application to: (1) include the incurred CHP System fuel costs, ground transportation costs, and related taxes, in its energy cost adjustment clause ("ECAC"), to the extent that said costs are not included in MECO's base rates; and (2) include the reasonable costs incurred by MECO pursuant to the CHP Agreement, in its revenue requirement for ratemaking purposes and for the purpose of determining the reasonableness of MECO's rates using the direct financing lease method or the alternative method proposed by MECO.

MECO makes its request pursuant to: (1) its Tariff Rule 4; (2) In re Public Util. Comm'n, Docket No. 03-0371, Decision and Order No. 22248, as amended by Order No. 22375; and (3) HAR § 6-60-6.

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<sup>24</sup>CHP Agreement, Sections 5.5, 5.6, and 5.11, at 9-11. Solely for MECO, the limitation of liability provision states:

Except for defense and indemnification obligations required under Section 5.5 above, MECO's aggregate liability under this Agreement arising out of or in connection with the performance or non-performance of this Agreement or any part thereof shall not exceed one year of estimated annual energy savings from the System.

CHP Agreement, Section 5.6, at 9.

<sup>25</sup>CHP Agreement, Section 5.14, at 11-12.

D.

Parties' Stipulation

After the completion of discovery, the Consumer Advocate, by its Statement of Position filed on January 18, 2007, as amended on February 7, 2007, informed the commission that it did not object to the commission's partial approval of MECO's Application, subject to MECO addressing the Consumer Advocate's stated concerns and proposed conditions.<sup>26</sup> On February 15, 2007, MECO filed its Reply Statement of Position.<sup>27</sup> In addition, on April 5, 2007, MECO, in response to the concerns reflected by the Consumer Advocate in its Statement of Position, submitted its further economic analysis of various Lanai generation capacity scenarios for comparison purposes.<sup>28</sup>

Following the completion of MECO's additional economic analysis, the Parties engaged in settlement discussions, culminating in the Stipulation filed with the commission on November 9, 2007.<sup>29</sup> As explained by the Parties, the Stipulation reflects their resolution of the issues in this proceeding.

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<sup>26</sup>Consumer Advocate's Statement of Position; and Certificate of Service, filed on January 18, 2007, as amended on February 7, 2007 (collectively, "Statement of Position").

<sup>27</sup>MECO's Reply Statement of Position; Attachment A; and Certificate of Service, filed on February 15, 2007 (collectively, "Reply Statement of Position").

<sup>28</sup>MECO's letter, dated April 5, 2007, with attachments (filed under partial confidential seal).

<sup>29</sup>See MECO's letter, dated April 5, 2007, at 2; and Stipulation, at 4.

By their Stipulation, the Parties stipulate and agree as follows:

1. An evidentiary hearing is not necessary in this docket. As a result, the Parties agree to waive their rights to (a) present further evidence and argument on the issues, and (b) conduct cross-examination of witnesses, and agree that the Commission may decide this matter on the basis of the record established by the submission of the Parties.
2. The Parties recommend that the Commission approve the CHP Agreement.
3. [The] [a]ttached Exhibit A, which is MECO's updated financial analysis of the Lanai generation capacity scenarios, appears to be reasonable based on the representations made and analyses provided by MECO and at this time demonstrates that the subject CHP System and CHP Agreement appear to be the lowest reasonable cost alternative. The updated analysis appears to meet the Commission's objectives and requirements as set forth in the relevant ordering paragraphs in Decision and Order No. 22238, as clarified by Order No. 22375, in Docket No. 03-0371 supporting the proposed CHP System and CHP Agreement. Notwithstanding, the Parties note that Exhibit A does not consider the "stranded cost" that is associated with the alternatives that include the loss of any of the C&C Resort[s] accounts, as such a loss may result in some MECO facilities being no longer "used and useful." The Parties have agreed that the issue of "stranded costs" is complex and the resolution of such an issue extends beyond the instant proceeding. Thus, the Parties recommend that the treatment of any stranded investment be more appropriately addressed in the context of a generic proceeding, or possibly a rate proceeding.
4. As shown on Exhibit A, the findings of the ratemaking treatment for the CHP Agreement as a direct-financing lease or a plant asset in MECO's rate base results in the CHP Agreement being the lowest reasonable cost alternative to Lanai's ratepayers. As such, the Parties have agreed that the proposed ratemaking treatment as either a direct-financing lease or as a plant asset can be addressed in

MECO's general rate proceeding following the commercial operation of the CHP System. Further, the Consumer Advocate reserves the right to review the reasonableness of the actual costs incurred by MECO pursuant to the CHP Agreement at this time.

5. MECO should be allowed to include the incurred CHP System fuel costs, ground transportation costs and related taxes in MECO's Lanai division ECAC pursuant to [HAR §] 6-60-6, to the extent that such costs are not included in MECO's base rates and net of any decreases in other costs (e.g., central station fuel costs) related to the subject CHP System and CHP Agreement that were included in MECO's last rate proceeding.
6. Approval of the subject CHP Agreement does not establish a precedent for the approval of other CHP system applications, and any future applications for approval of CHP systems will be evaluated on a case-by-case basis based on the merits of the proposals provided in the applications.

Stipulation, 5-7 (footnote and text therein omitted).

E.

Responses to Commission's Information Requests

In reviewing the Parties' Stipulation, the commission, on November 15, 2007, issued its first set of information requests, seeking clarifying, additional, and updated information. On December 17, 2007, MECO responded to the commission's first set of information requests, as follows:

1. "MECO estimates completion of construction of the CHP System approximately 12 months after receiving a PUC approval order for the project. A project development schedule is provided on the second page of this response showing construction completion at the end of 2008, based on a January [2008] PUC

approval. Testing of the CHP System would occur in January 2009."<sup>30</sup>

2. In Exhibit A of the Parties' Stipulation, MECO updated its April 2007 economic analysis of various Lanai generation capacity scenarios. In effect, "[t]he agreed upon revisions do not change the conclusion that the CHP Agreement results in the lowest reasonable cost alternative to Lanai's ratepayers. Both MECO and the Consumer Advocate agreed that the updated financial analysis in Exhibit A is reasonable and sufficiently demonstrates that Lanai's ratepayers are better off with the CHP Agreement."<sup>31</sup>

3. MECO reiterates that it meets the criteria set forth in In re Public Util. Comm'n, Docket No. 03-0371, Decision and Order No. 22248, as amended by Order No. 22375, governing a regulated utility's sale of DG services to a customer.<sup>32</sup>

4. The Parties have reached agreement on MECO's request to include the incurred CHP System fuel costs, ground transportation costs, and related taxes in MECO's Lanai Division's ECAC.<sup>33</sup>

5. MECO's proposals to submit to the commission and the Consumer Advocate an annual status report and an initial

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<sup>30</sup>MECO's response to PUC-IR-101.

<sup>31</sup>MECO's response to PUC-IR-102.

<sup>32</sup>See MECO's response to PUC-IR-103.

<sup>33</sup>See MECO's response to PUC-IR-104.

cost report, "as specified in its Application at pages 35-36, remain in effect."<sup>34</sup>

Thereafter, on January 9, 2008, the commission issued PUC-IR-201, to which MECO responded on January 31, 2008. In its response to PUC-IR-201, MECO asserts:

1. The pricing structure reflected in the CHP Agreement is not inconsistent with In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, which states that "the utility should not be able to offer a discount from regulated rates as an inducement to the customer to choose the utility's distributed generation."

2. "MECO does not consider its proposed CHP electrical energy rate as a 'discount from regulated rates,' rather MECO elected to peg the proposed CHP electrical energy rate for the project to the price of grid-supplied energy (i.e., Schedule P tariff), minus a set \$0.015/kWh. MECO is not discounting the price of energy supplied from the Lanai system grid."<sup>35</sup>

3. The CHP System and CHP Agreement, including the proposed pricing structure, are intended to serve multiple objectives in the interests of MECO, C&C Resorts, and all Lanai ratepayers. Specifically:

The proposed MECO CHP project is explicitly intended to (1) more optimally serve MECO's Lanai system needs for generating capacity, and (2) provide net energy cost savings to C&C Resorts, thereby retaining C&C Resorts as a MECO customer and preventing the loss of

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<sup>34</sup>MECO's response to PUC-IR-105.

<sup>35</sup>MECO's response to PUC-IR-201, at 2 (emphasis in original).

a substantial amount of fixed cost recovery, which would otherwise severely harm other MECO Lanai ratepayers. With regard to the first objective, MECO is able to site new generation at a distributed site, better time the generating unit addition in accordance with the utility system's need, and custom design the CHP control modes to allow MECO operators greater flexibility in controlling the CHP System to match Lanai grid conditions. With regard to the second objective, MECO provided detailed economic analyses in its response to PUC-IR-102 showing that implementation of the proposed CHP System and Agreement and retaining of the C&C Resorts loads on the MECO Lanai system is in the interests of MECO's other Lanai Division customers.

MECO documented in response to CA-IR-3 that it set the CHP pricing structure for the CHP Agreement to provide approximately \$250,000 in total annual energy cost savings benefits to C&C Resorts, including energy cost savings provided by reduced use of electric chillers and other equipment. This is equivalent to the amount of savings that was being provided by MECO to C&C Resorts under [the] service contract, approved by the Commission in Docket No. 03-0261[.]

. . . . .

Thus, in order to achieve the objective of retaining C&C Resorts as a MECO customer, it was necessary for MECO to structure the CHP System and Agreement to provide C&C Resorts with energy cost savings roughly equivalent to the Service Contract. The proposed CHP System and Agreement accomplishes this primarily through reduced usage of the electric chillers at the C&C Resorts' hotel, with a lesser amount of savings provided by the CHP pricing structure.

. . . . . MECO chose to structure its price for the electrical energy supplied to C&C Resorts from the proposed CHP System based on the price of grid-supplied energy (i.e., MECO's Schedule P tariff), less \$0.015/kWh. By linking a small portion of potential energy cost savings directly to the production of energy from the CHP System, MECO felt this created a shared interest on the part of both MECO and C&C Resorts to support the operation and maintenance of the CHP System.

MECO appreciates that pegging the CHP electricity price to the Schedule P tariff minus \$0.015/kWh could be interpreted on its face to be counter to the Commission's direction in Order No. 22375. Indeed, MECO could have chosen an alternative form of pricing the CHP electricity, such as by setting a stand-alone CHP electricity rate not explicitly linked to the Schedule P tariff. However, MECO's objectives to provide approximately \$250,000 in annual energy cost savings to C&C Resorts via the CHP project, in order to simultaneously meet the needs of the MECO Lanai system and serve the economic interests of other Lanai ratepayers, would have been unchanged.

Based on the above, MECO considers the proposed CHP System and Agreement, including the proposed CHP pricing structure, to be reasonable and in the interests of ratepayers, especially considering the unique context of the project objectives.

MECO's response to PUC-IR-201, at 2-5 (emphasis added).

## II.

### Waiver of Evidentiary Hearing

Exhibit 1 of Order No. 22837, filed on September 11, 2006, sets forth the schedule of proceedings agreed-upon by the Parties, and as modified by the commission. Page 3 of Exhibit 1 states in part that following the filing of MECO's Reply Statement of Position, "the parties will meet informally to attempt to reach a stipulation on issues where there is agreement and/or partial agreement, and/or establish additional procedural steps, as required."<sup>36</sup> Further, the establishment of any additional procedural steps may include an evidentiary hearing, subject to the commission's approval.

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<sup>36</sup>Order No. 22837, Exhibit 1, at 3.



Here, the Parties, by their Stipulation, affirmatively waive an evidentiary hearing in this proceeding. The commission approves the Parties' intentional and voluntary waiver of an evidentiary hearing.

### III.

#### Discussion

##### A.

#### The CHP System and CHP Agreement

MECO's Tariff Rule 4 provides:

Special contracts for service other than that provided under the tariffs or attached form contracts must be authorized by the Public Utilities Commission prior to the effective date of said contract.

Each contract for service will contain a statement that it shall at all times be subject to changes or modifications by the Public Utilities Commission as said Commission may from time to time direct in the exercise of its jurisdiction.

MECO Tariff Rule 4.

As noted by the Consumer Advocate, "[t]he proposed CHP System is essentially a utility owned DG system that will be installed at the customer's premise for the purpose of serving the customer's energy needs."<sup>37</sup> In this regard, Section II.B of Decision and Order No. 22248, issued in In re Public Util. Comm'n, Docket No. 03-0371, relating to a utility's ownership of distributed generation facilities, provides in relevant part:

If the utility wishes to sell distributed generation services as a regulated utility, the

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<sup>37</sup>Consumer Advocate's Statement of Position, at 6.

utility must show, in an application filed with the commission, the following:

- (a) the distributed generation resolves a legitimate system need;<sup>38</sup>
- (b) the distributed generation proposed by the utility is the least cost alternative to meet that need;<sup>39</sup> and
- (c) in an open and competitive process acceptable to the commission, the customer-generator was unable to find another entity ready and able to supply the proposed distributed generation service at a price and quality comparable to the utility's offering.<sup>40</sup>

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<sup>38</sup>By Order No. 22375, the commission clarified that:

. . . . . The evaluation as to whether a specific proposed utility-owned distribution generation project meets the legitimate system need criteria must be based on the specific information contained in the application for commission approval to proceed with the project. Accordingly, the applicability of any one or more of the benefits of distributed generation identified in Section II.C of Decision and Order No. 22248 should not in and of itself be construed as a guarantee of a finding of a legitimate system need.

In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, at 10 (emphasis added).

<sup>39</sup>By Order No. 22375, the commission clarified that the term "least cost alternative" means the same as "lowest reasonable cost," as used in Section II(A) of the commission's Integrated Resource Planning Framework, dated May 22, 1992. In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, at 12-14.

<sup>40</sup>The HECO Companies, as part of their motion for clarification, suggested a process that may satisfy requirement (c), including the filing of a written declaration by a customer that pursues a distributed generation project with the regulated utility. In response, the commission noted in part:

. . . . . At a minimum, the utility would be well advised to require the customer to include in its declaration a list of the companies that submitted proposals that were considered by the customer. In addition, it would be prudent for the utility to require the customer to include in its declaration to the commission the details of the terms of the utility's offer to the customer, so that the commission may determine whether the utility is attempting to utilize

Docket No. 03-0371, Decision and Order No. 22248, at 22 - 23 (footnotes, text therein, and emphasis added); see also id. at 20 and 46, Ordering ¶ No. 2.

MECO notes that its Lanai-based system and the Lanai energy market are unique. According to MECO, the three facilities owned by C&C Resorts - the Hotel, Lodge at Koele, and its Central Services Facility - make C&C Resorts the single largest customer on Lanai, accounting for approximately forty percent of MECO's Lanai Division's production of electricity.

By their Stipulation, the Parties recommend that the commission approve the CHP Agreement, essentially concurring that the CHP System and Agreement "appear[] to meet the Commission's objectives and requirements as set forth in the

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an unfair advantage as a regulated utility, which is the concern expressed by [Hawaii Renewable Energy Alliance ("HREA")].

The foregoing guidance, however, should not be construed as a pre-approval of the proposed process that is binding on the commission, as the commission will make such a determination when a utility files an application containing the details of a specific project with the commission. Moreover, the commission agrees with HREA's concern that the utility should not be able to offer a discount from regulated rates as an inducement to the customer to choose the utility's distributed generation. The commission is committed to encouraging a competitive market for distributed generation services. If a utility engages in behavior inconsistent with that goal, the commission will entertain recommendations for restricting utility opportunities in distributed generation.

In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, at 22 (emphasis added).

relevant ordering paragraphs in Decision and Order No. 22238, as clarified by Order No. 22375, in Docket No. 03-0371[.]"<sup>41</sup>

1.

Legitimate System Need

The Stipulation does not specifically refer to or discuss the legitimate system need criteria. Nonetheless, as part of the docket record, MECO states that the CHP System will:

1. Meet MECO's need for additional generating capacity on Lanai under the base plan scenario for MECO's Lanai Division.<sup>42</sup>

2. Provide a net 884 kW of capacity, accounting for CHP System output, electric chiller load offset, and auxiliary loads.

3. Be capable of operating in a "peak mode" setting, allowing MECO to dispatch the unit at its full generating unit capacity, regardless of the thermal energy loads of the Hotel.<sup>43</sup>

4. Enable MECO to satisfy the energy cost savings objectives of its Service Contract with C&C Resorts, allowing recovery of fixed cost contributions and stability of Lanai rates.

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<sup>41</sup>Stipulation, at 5.

<sup>42</sup>See MECO's 2006 Adequacy of Supply Report, at 13.

<sup>43</sup>According to MECO: (1) the 884 kW net capacity of the CHP System at the Hotel represents seventeen percent of Lanai system's peak load; and (2) the CHP System is comparable in size to generating units at MECO's Miki Basin Generating Station.

MECO also notes:

1. MECO's Miki Basin EMD units LL-1 through LL-6 are currently between 45 to 56 years old, and that the de-rating of these six EMD units from 6,000 kW to 5,000 kW for generation planning purposes is prudent, given the age of the EMD units, difficulty in obtaining replacement parts, and the cost of such repair work

2. MECO properly considered other options such as modifying unit maintenance schedules, and any decision to invest funds to restore the EMD units to their name-plate ratings in lieu of investing in the CHP System will not address C&C Resorts' objective of achieving energy cost savings.

3. "[A]s described in MECO's response to PUC-IR-101, [the] completion of construction of the CHP System is now projected for the end of 2008. MECO has reviewed its unit overhaul schedules for Miki Basin Generating Station units LL-7 and LL-8 to take the revised CHP System schedule into account. MECO has determined that the overhaul for Unit LL-8 cannot be deferred into 2009 and in fact must be scheduled for June 2008 based on unit run hours. MECO plans to implement mitigation measures to avoid shedding load in the event of loss of the largest unit (2.2 MW unit) during the day peak during the period that unit LL-8 is out of service for overhaul. MECO has determined that the overhaul of Unit LL-7, scheduled for October 2008, can be deferred to January 2009 without undue risk

to the unit. Thus, there is a continued system need for the CHP System."<sup>44</sup>

The determination as to whether MECO's CHP System "meets the legitimate system need criteria must be based on the specific information contained in the application for commission approval to proceed with the project."<sup>45</sup> Here, the commission finds that the CHP System appears to meet a legitimate system need of supplying additional generation capacity on Lanai, in particular to MECO's single largest customer on Lanai, while MECO, as part of its Lanai Division operations, proceeds with de-rating six EMD units (LL-1 through LL-6) that are approaching the end of their useful service lives, within the context of scheduling maintenance overhauls of two other EMD units (LL-7 and LL-8). Moreover, the installation of the CHP System is consistent with MECO's objective of maintaining the recovery of fixed contribution costs from its single largest customer on Lanai, in lieu of having said customer removing itself completely from MECO's grid. Accordingly, the commission finds that the MECO-owned CHP System is consistent with the paragraph (a) requirement governing legitimate system need, as set forth in Decision and Order No. 22248, Section II.B, as amended by Order No. 22375.

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<sup>44</sup>MECO's response to PUC-IR-103.

<sup>45</sup>In re Public Util. Comm'n, Docket No. 03-0371, Order No. 22375, at 10.

Lowest Reasonable Cost

MECO contends that the CHP System meets the standard of lowest reasonable cost, provides significant additional value to MECO and its Lanai ratepayers (when compared with installing an additional generating unit at the Miki Basin Generating Station), and is consistent with the interests of MECO, Lanai ratepayers, and C&C Resorts. In particular, MECO states:

1. The CHP System will benefit Lanai ratepayers by preventing the loss of a substantial amount of fixed costs recovery, and Lanai ratepayers will not be negatively impacted by the CHP Agreement, as revenues from C&C Resorts are projected to exceed the revenue requirement of the capital investment in and operation and maintenance costs of the CHP System.

2. While MECO will incur some additional costs of fuel transportation, fuel storage, and metering by installing the CHP System at the Hotel, "[t]hese costs will be offset by lower costs of permitting the unit at the Hotel versus modifying the existing federal and state operating permits for the Miki Basin Generating Station, and by the avoidance of transmission losses."<sup>46</sup> Meanwhile, the costs of installing the thermal energy recovery equipment associated with the CHP System are largely recovered from C&C Resorts by the monthly facilities fee.

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<sup>46</sup>MECO's Application, at 24.

3. The amount of energy cost savings to C&C Resorts following the installation of the CHP System is estimated at \$250,000 to \$300,000 per year. "The majority of savings is provided by the reduced usage of the Hotel's electric chillers and the corresponding net reduction of electrical energy use by the Hotel. Additional savings are provided by the production of domestic hot water from the CHP System, displacing the need for C&C Resorts to operate existing heat pumps."<sup>47</sup> Thus, the CHP System will provide annual cost savings equivalent to the three-year annual discount of \$250,000 it currently receives under its Service Contract with MECO, which was scheduled to expire on February 24, 2007.

4. In 2003, C&C Resorts was pursuing a self-generation option that would have completely removed all of its Lanai-based facilities, including the Hotel, from MECO's grid. Under this scenario, Lanai's remaining ratepayers would have been significantly and adversely affected by a DG system installed at the Hotel by either C&C Resorts or a third-party. Instead, the MECO-owned CHP System will enable MECO to continue its recovery of fixed cost contributions from C&C Resorts by having the Hotel remain on MECO's grid.

5. The CHP System offers an economically viable option to meeting the combined objectives of adding generation capacity and serving customer needs. In this regard, MECO's analysis shows that: (A) the estimated revenues to be received from C&C Resorts exceed the CHP System's revenue

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<sup>47</sup>MECO's Application, at 7.



requirement in each year of the CHP Agreement, meaning that estimated revenues from C&C Resorts will be sufficient to cover MECO's incremental investment in the CHP System; and (B) other Lanai Division ratepayers will be better off with a MECO CHP System at the Hotel rather than a comparable non-utility CHP system, benefiting annually by an average of \$164,000 and by approximately \$3.3 million over the term of the CHP Agreement. In effect, MECO's CHP System scenario is preferable to the C&C Resorts' CHP system scenario from a ratepayer perspective, resulting in an average nominal annual savings of \$164,000 to Lanai ratepayers as compared to a non-utility owned CHP system.

6. MECO has appropriately considered alternative Lanai electrical generation scenarios, and a significant potential for stranded investment exists if MECO does not install the CHP System.<sup>48</sup> MECO reiterates that if MECO is unable to install the CHP System and maintain cost savings for C&C Resorts, C&C Resorts considers self-generation as a viable option to purchasing energy from MECO, and thus, could implement its prior plans to install 2.7 MW of generation at the Hotel and completely leave MECO's grid. In effect, "C&C [could] implement self-generation at one or more of its Lanai facilities that goes well beyond the capacity of MECO's proposed CHP System, leaving MECO with potential stranded investment and the loss of a significant amount of contribution to fixed costs."<sup>49</sup>

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<sup>48</sup>See MECO's Reply Statement of Position, Section II(1), at 5-8.

<sup>49</sup>MECO's Reply Statement of Position, at 6.

7. MECO focused its analysis on MECO, C&C Resorts, or a third-party installing the CHP System.

MECO's most recent economic analysis of various Lanai generation capacity scenarios for comparison purposes is set forth in Exhibit A of the Parties' Stipulation ("MECO's Economic Analysis"), and is further discussed and explained by MECO in its responses to the commission's information requests.<sup>50</sup>

Specifically, MECO analyzed and compared the following three scenarios as part of its Economic Analysis: (1) the installation and operation of MECO's CHP System at the Hotel, with an in-service date of January 2009; (2) the complete separation of the Hotel from MECO's grid, with C&C Resorts or a third-party self-generating electricity for the Hotel, beginning in January 2009; and (3) the complete loss of the twelve C&C Resorts accounts from MECO's grid, beginning in January 2009.<sup>51</sup> As explained by MECO:

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<sup>50</sup>Certain portions of Exhibit A of the Parties' Stipulation and MECO's responses to the commission's information requests are filed under partial confidential seal.

<sup>51</sup>According to MECO:

A separate scenario in which C&C Resorts simply continues to be served by MECO's Miki Basin Generating Station, and a Miki Basin generating unit is added in 2009, was not considered in the system economic analysis, given that this would not provide C&C Resorts with its needed energy cost reductions. A status quo situation with no generation addition on Lanai in 2009 was also not considered due to the identified need for additional generating capacity in late 2008.

MECO's response to PUC-IR-102, Attachment 1, at 5 n.1.

The primary objectives of the analysis were to compare the impacts to other Lanai Division customers in each scenario, capturing changes in system costs related to the loss of C&C Resorts' load, and to consider MECO's revenues versus system costs. MECO's analysis incorporates certain simplifying assumptions in calculating Lanai system costs and projects these costs in each of the scenarios over a twenty year analysis period. The analysis includes costs associated with installing and operating the CHP system, Miki Basin Generating Station costs, and costs of any future MECO generating unit additions that were determined to be needed during the twenty year period.

MECO's response to PUC-IR-102, Attachment 1, at 5-6.

Based on its Economic Analysis, MECO "concluded that other Lanai Division customers would be better off with a MECO CHP system at the Hotel compared to having [the] twelve C&C Resorts accounts leave the grid. The incremental costs in total dollars and cents per kWh are significantly higher in these two scenarios and a higher proportion of the system costs would be borne by other Lanai Division customers. Since the lost [of] C&C Resorts' load in these two scenarios are significant in relation to the total Lanai system, other Lanai Division customers would bear a significant portion of this cost."<sup>52</sup>

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<sup>52</sup>MECO's response to PUC-IR-102, at 13. As concluded by MECO, in its Economic Analysis:

Scenario 1, installation of a MECO CHP system at the Hotel, results in the lowest incremental cost to Lanai ratepayers assuming ratemaking treatment of the CHP Agreement as a direct-financing lease or as a plant asset in rate base.

Significantly higher incremental costs to Lanai ratepayers occur in Scenarios 2 and 3. The incremental costs to remaining Lanai ratepayers under these scenarios are two to three times higher than the costs under Scenario 1.

On an incremental cost per [kWh] basis, impacts are significantly lower in Scenario 1. This is logical

The Parties stipulate that Exhibit A, i.e., MECO's Economic Analysis, "appears to be reasonable based on the representations made and analyses provided by MECO and at this time demonstrates that the subject CHP System and CHP Agreement appear to be the lowest reasonable cost alternative [for Lanai's ratepayers.]"<sup>53</sup> Upon review, the commission concurs with the Parties' assessment that the installation and operation of MECO's CHP System at the Hotel appears to meet the lowest reasonable cost criteria of paragraph (b), as set forth in Decision and Order No. 22248, Section II.B, as amended by Order No. 22375.

3.

Open and Competitive Process

MECO's Application is supported by the affidavit of C&C Resorts' Executive Vice President, who avers in respective part:

3. C&C Resorts uses approximately 16,000,000 kWh of electricity per year for its operations on the island of Lanai, including the Four Seasons Resort Lanai at Manele Bay.
4. This affidavit is made in support of [MECO's] Application for Approval of a Combined Heat and Power Agreement with Castle & Cooke Resorts, LLC, dated June 16, 2006, governing MECO's proposed installation of a [CHP] system at the Four Seasons Resort Lanai at Manele Bay.

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considering that, in Scenarios 2 and 3, there are much fewer MECO kWh sales over which to distribute the incremental costs.

MECO's response to PUC-IR-102, Attachment 1, at 6.

<sup>53</sup>Stipulation, at 5; see also MECO's responses to PUC-IR-102 and PUC-IR-103.

5. C&C Resorts was able to satisfy its imminent need in 2003 to reduce the energy costs of its resort operations on Lanai through the temporary rate reduction for the Manele Bay Hotel included in the MECO Service Contract approved by the Hawaii PUC in February 2004, which was amended as requested by the PUC in the approval order, and the installation of energy conservation measures.
6. The MECO Service Contract expires in February 2007, and C&C Resorts needs to pursue energy cost reductions on a permanent basis. The principal means to achieve those savings is through the installation of on-site diesel engine generator CHP systems.
7. In considering its non-utility distributed generation ('DG') option versus MECO's proposed CHP system, C&C Resorts prefers the MECO CHP system due in part to the negative electric rate impacts that might be experienced at C&C Resorts' other facilities on Lanai and by other Lanai customers, many of whom are C&C Resorts employees, if the hotel were to self-generate or be supplied power by a non-utility generator. C&C Resorts also recognizes the additional value provided by MECO's continuous on-island presence, with MECO diesel engine mechanics capable of providing more timely trouble response than non-utility entities.
8. If MECO is unable to obtain approval to install the proposed CHP system, Affiant considers the installation of on-site generators to be a viable alternative to purchasing electricity from MECO under existing electricity tariffs.
9. Affiant is aware of C&C Resorts' non-utility options for self-generation, as indicated by C&C Resorts' plans and permitting activities in 2003 to purchase and install (1) six 455 kW Caterpillar diesel engine generators to provide electricity for its hotel now known as the Four Seasons Resort Lanai at Manele Bay, (2) three 455 kW Caterpillar diesel engine generator CHP systems to provide electricity and hot water for its hotel known as The Lodge at Koele located outside of Lanai City, and (3) three 365 kW Caterpillar diesel engine generator CHP systems to provide electricity and hot water for its Central Services facility located in Lanai City. The installation of approximately 5 MW of on-site generation was intended to provide sufficient

redundant generation at all three sites (representing 17 MECO accounts and about 2,300 kW of peak load) so as to bypass MECO's system entirely for the three facilities.

10. Affiant has entered into an agreement with MECO for a MECO-supplied CHP system at the Four Seasons Resort Lanai at Manele Bay because the MECO CHP offering, compared with other available options, provides the greatest range of benefits and value to Affiant, its employees, and the community of Lanai. Affiant believes that the proposed MECO CHP system will best serve the needs of C&C Resorts' Lanai operations in conjunction with meeting the electric service needs of the island of Lanai, and that expeditious PUC approval of said CHP system is in the best interests of all concerned.

Affidavit of Timothy Hill, C&C Resorts' Executive Vice President,  
at 1-2.

MECO contends that it has met the open and competitive process criteria under paragraph (c) of Decision and Order No. 22248, Section II.B, as amended by Order No. 22375. Specifically, MECO states that "C&C Resorts has appropriately documented its consideration of a specific non-utility DG offering, which remains a viable option, and its determination that the MECO CHP proposal is its desired option."<sup>54</sup>

The Stipulation does not specifically refer to or discuss the criteria governing an open and competitive process. Concomitantly, the commission recognizes that the island of Lanai represents a small, unique market for the generation and supplying of electricity by the franchised utility, where C&C Resorts is the single largest customer of Lanai, accounting for approximately forty percent of MECO's Lanai Division's production of electricity.

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<sup>54</sup>MECO's Application, at 27.

Under this scenario, C&C Resorts represents that, as part of exploring its cost-effective and competitive alternatives to maintaining its service connections with MECO's grid, the installation of twelve CHP systems for its three properties that are intended to fully bypass MECO's grid, remains a viable option. Nonetheless, after considering its options and alternatives, C&C Resorts prefers to install the MECO-owned CHP System for its Hotel, "due in part to the negative electric rate impacts that might be experienced at C&C Resorts' other facilities on Lanai and by other Lanai customers, many of whom are C&C Resorts employees, if the hotel were to self-generate or be supplied power by a non-utility generator. C&C Resorts also recognizes the additional value provided by MECO's continuous on-island presence, with MECO diesel engine mechanics capable of providing more timely trouble response than non-utility entities."<sup>55</sup>

Here, the commission finds that, consistent with the intent of the open and competitive process criteria governing utility-owned DG, the customer-generator in this instance, C&C Resorts, has thoroughly explored its options and alternatives, including its option to self-generate, and appears to have been "unable to find another entity [that is] ready and able to supply the proposed distributed generation service at a price and quality comparable to the utility's offering." In effect, C&C Resorts has made a business decision to enter into the CHP Agreement with MECO, as its most viable option.

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<sup>55</sup>Affidavit of Timothy Hill, C&C Resorts' Executive Vice President, at 1-2.

Under the specific circumstances of the CHP System project, the commission concludes that MECO has sufficiently shown that, in an open and competitive process acceptable to the commission, the MECO-owned CHP System meets the paragraph (c) requirement set forth in Decision and Order No. 22248, Section II.B, as amended by Order No. 22375.

4.

MECO-Owned CHP System

Under MECO's interpretation, by "pegging" the electrical energy pricing component of the CHP Agreement to MECO's Schedule P tariff, less \$0.015/kWh, MECO is not discounting the price of energy supplied from its grid. In effect, because the source of the electricity provided to the Hotel is the CHP System, MECO is not discounting the price of electricity supplied from its grid. Thus, MECO does not consider the electrical energy pricing component to be inconsistent with the commission's observations in Order No. 22375 that "the utility should not be able to offer a discount from regulated rates as an inducement to the customer to choose the utility's distributed generation."

The commission does not necessarily concur with MECO's narrow interpretation. Here, MECO seeks the commission's approval to provide DG services as a regulated utility and provider of energy under which the rates are subject to the commission's approval. Moreover, the electric energy pricing component set forth in the CHP Agreement clearly provides that



the Hotel will be billed under MECO's applicable rate schedule, and all of the schedule's provisions shall apply, except for the electric energy rate discount provisions set forth in the CHP Agreement.<sup>56</sup> In addition, as asserted by MECO in this proceeding, the CHP System meets the legitimate system need criteria articulated in Decision and Order No. 22248, Section II.B, as amended by Order No. 22375, by providing additional generation capacity on Lanai under the base plan scenario for MECO's Lanai Division. Lastly, the CHP System will be interconnected with MECO's grid, and in the event of any failure of the CHP System, the Hotel's electric system will automatically access energy from MECO's grid. In sum, MECO's interpretation, if accepted herein, will appear to render virtually meaningless the commission's pronouncement that "the [regulated] utility should not be able to offer a discount from regulated rates as an inducement to the customer to choose the utility's distributed generation."

That said, the commission finds that under the unique circumstances of the Lanai energy market, as noted by MECO in this docket record, the energy rate discount provisions set forth in the CHP Agreement, standing alone, do not constitute a sufficient basis for rejecting the CHP Agreement, as inconsistent with the commission's pertinent observations in Order No. 22375.<sup>57</sup>

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<sup>56</sup>MECO's Application, Exhibit 1, Appendix B (Electric Energy Pricing/Electric Energy Rate Discount).

<sup>57</sup>See, e.g., MECO's response to PUC-IR-201 (MECO's discussion of its multiple objectives).

The energy rate discount provisions, as represented by MECO, are designed to achieve the equivalent amount of cost savings that MECO was providing to C&C Resorts under the Service Contract approved by the commission in Docket No. 03-0261, as an inducement to having the Hotel remain on-line as a MECO customer. Concomitantly, the MECO-owned CHP System will enable MECO to continue its recovery of fixed cost contributions from C&C Resorts by having the Hotel remain on MECO's grid. Moreover, under MECO's Economic Analysis: (1) the estimated total revenues from C&C Resorts will be sufficient to cover the utility's incremental investment in the CHP System; and (2) the installation of a MECO-owned CHP System, when compared to the installation of a non-utility owned system, will result in an average annual savings of approximately \$164,000 for Lanai's ratepayers. Furthermore, from C&C Resorts' perspective, it "recognizes the additional value provided by MECO's continuous on-island presence, with MECO diesel engine mechanics capable of providing more timely trouble response than non-utility entities."<sup>58</sup>

B.

Commission's Approval

Based on the reasons set forth in Section III.A, above, the CHP System appears consistent with the requirements set forth in Decision and Order No. 22248, Section II.B, as amended by

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<sup>58</sup>Affidavit of Timothy Hill, C&C Resorts' Executive Vice President, at 2.

Order No. 22375, governing MECO's proposal to sell DG services as a regulated utility. The commission also finds that the electric energy rates MECO intends to charge the Hotel pursuant to the CHP Agreement do not appear to constitute "unreasonable discrimination between localities or between users of consumers under substantial similar conditions," which is prohibited under HRS § 269-16(b)(2)(B).<sup>59</sup>

Consistent with the commission's rationale in In re Maui Elec. Co., Ltd., Docket No. 03-0261, the discount in energy rates for C&C Resorts appears "reasonable and in the public interest, particularly in light of [the] potential loss of revenues to MECO and the impact on the remaining [Lanai]

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<sup>59</sup>HRS § 269-16(b) provides in relevant part:

(b) No rate, fare, charge, classification, schedule, rule, or practice, other than one established pursuant to an automatic rate adjustment clause previously approved by the commission, shall be established, abandoned, modified, or departed from by any public utility, except after thirty days' notice to the commission as prescribed in section 269-12(b), and prior approval by the commission for any increases in rates, fares, or charges . . . . The commission, upon notice to the public utility, may:

. . . . .

(2) After a hearing, by order:

. . . . .

(B) Prohibit rebates and unreasonable discrimination between localities or between users or consumers under substantially similar conditions;

. . . . .

HRS § 269-16(b).

ratepayers."<sup>60</sup> In essence, the benefits of having the Hotel remain on-line as a MECO customer, at a discounted energy rate, appear to outweigh the potential negative effects on the other remaining Lanai ratepayers, should C&C Resorts completely remove the Hotel from MECO's grid and self-generate its electricity. In addition, of particular note, "[n]o rate recovery is requested for any revenue reduction resulting from the CHP Agreement between the time the CHP Agreement goes into

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<sup>60</sup>In re Maui Elec. Co., Ltd., Docket No. 03-0261, Decision and Order No. 20811, at 4. As noted by the commission in Docket No. 03-0261:

MECO is proposing to provide an annual discount of \$250,000 for electric service to C&C Resorts for the Manele Bay Hotel on the island of Lanai. The discount will be provided for three years, or until final installation and operation of a CHP system at Manele Bay Hotel, whichever occurs first. According to MECO, the three-year term was negotiated between MECO and C&C Resorts. MECO states that the \$250,000 amount was a compromise between MECO's initial offer of \$150,000 and C&C Resorts' objective to save approximately \$500,000 per year. MECO also represents that the three-year term also would allow time to install additional generation to meet future customer demand on Lanai closer to the time when generation is needed.

MECO asserts that it plans to absorb the cost of the \$250,000 discount and does not plan to seek cost recovery of the discount. MECO further represents that it does not plan to have a rate case within the three-year term of the service agreement.

. . . . .

Upon review, the commission finds that the \$250,000 discount to C&C Resorts is reasonable and in the public interest, particularly in light of [the] potential loss of revenues to MECO and the impact on the remaining ratepayers. The commission notes that, at the most, the discount is only for a period of three[]years and the commission intends to revisit the issues of customer retention discounts in its pending investigation concerning distributed generation in Hawaii, Docket No. 03-0371.

In re Maui Elec. Co., Ltd., Docket No. 03-0261, Decision and Order No. 20811, at 3-4 (footnotes and text therein omitted).

effect until MECO's next general rate case (with a test year in which the CHP System is in service)."<sup>61</sup>

Lastly, consistent with MECO's Tariff Rule 4, the CHP Agreement "is at all times subject to changes and modifications as the PUC may direct from time to time in the exercise of its jurisdiction."<sup>62</sup>

The commission, thus, approves the CHP Agreement, as recommended by the Parties.

C.

ECAC

HAR § 6-60-6 states in pertinent part:

Automatic adjustment clauses. The utility's rate schedules may include automatic rate adjustment clauses, only for those clauses previously approved by the commission. Upon [the] effective date of this Chapter, any fuel adjustment clause submitted for commission approval shall comply with the following standards:

- (1) 'Fuel adjustment clause' means a provision of a rate schedule which provides for increases or decreases or both, without prior hearing, in rates reflecting increases or decreases or both in costs incurred by an electric or gas utility for fuel and purchased energy due to changes in the unit cost of fuel and purchased energy.
- (2) No changes in fuel and purchased energy costs may be included in the fuel adjustment clause unless the contracts

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<sup>61</sup>MECO's Application, at 34.

<sup>62</sup>CHP Agreement, Section 5.14, at 11-12.

or prices for the purchase of such fuel or energy have been previously approved or filed with the commission.

. . . . .

HAR § 6-60-6.

The Parties agree that MECO should be allowed to include the incurred CHP System fuel costs, ground transportation costs, and related taxes, in MECO's Lanai Division's ECAC pursuant to HAR § 6-60-6, to the extent that such costs are not included in MECO's base rates, and net of any decreases in other costs (e.g., central station fuel costs) related to the CHP System and CHP Agreement that were included in MECO's last rate proceeding. In support thereto, MECO, in its response to PUC-IR-104, states that "[t]he Manele Bay CHP System is utility-owned and operated and will serve MECO's Lanai Division generating capacity needs in place of a new diesel generating unit at Miki Basin Generating Station. Thus, the incurred fuel, transportation costs, and related taxes, are properly included as utility-owned generation in the Lanai Division ECAC . . . . As a result, MECO intends to include the Manele Bay CHP unit as a separate plant in the Generation Component of Lanai's ECAC."<sup>63</sup>

The commission, consistent with HAR § 6-60-6(2), approves MECO's request to include the incurred CHP System fuel costs, ground transportation costs, and related taxes, in MECO's Lanai Division's ECAC, to the extent that such costs are not included in MECO's base rates, and net of any decreases in

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<sup>63</sup>MECO's response to PUC-IR-104.

other costs related to the CHP System and CHP Agreement that were included in MECO's last rate proceeding.

D.

Regulatory Treatment

MECO does not seek rate recovery for any decrease in revenues resulting from the CHP Agreement between the time the agreement takes effect until its next general rate case, with a test year in which the CHP System is already operating and in-service. That said, MECO, as part of its Application, initially sought to include the reasonable costs it incurs pursuant to the CHP Agreement, in its revenue requirement for ratemaking purposes and for the purpose of determining the reasonableness of MECO's rates using the direct financing lease method or the alternative method proposed by MECO.

Now, as part of the Stipulation, "the Parties have agreed that the proposed ratemaking treatment as either a direct-financing lease or as a plant asset can be addressed in MECO's general rate proceeding following the commercial operation of the CHP System. Further, the Consumer Advocate reserves the right to review the reasonableness of the actual costs incurred by MECO pursuant to the CHP Agreement at that time."<sup>64</sup>

MECO, in effect, withdraws its request to include the reasonable costs it incurs pursuant to the CHP Agreement, in its revenue requirement for ratemaking purposes and for the purpose of determining the reasonableness of MECO's rates using the

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<sup>64</sup>Stipulation, at 6; accord MECO's response to PUC-IR-102.

direct financing lease method or the alternative method proposed by MECO. Accordingly, no commission action is necessary in this proceeding with respect to MECO's request.

E.

Stranded Costs

The Parties, in their Stipulation, define the term "stranded costs" as follows:

For purposes of this stipulation, stranded costs or stranded investment is defined as plant, property, and/or equipment that was originally acquired to serve a customer or group of customers, but is eventually replaced earlier than expected by an alternative or alternatives where the customer or group of customers leave the system. As a result, the original plant, which was originally acquired to serve that customer or load is not entirely used and useful, becomes "stranded" and issues, such as recovery of the remaining net book value must be addressed.

Stipulation, at 6-7 n.1.

The Parties, as part of their Stipulation, agree that the issue of stranded costs is complex, and that "the resolution of such an issue extends beyond [this] proceeding. Thus, the Parties recommend that the treatment of any stranded investment be more appropriately addressed in the context of a generic proceeding, or possibly a rate proceeding."<sup>65</sup>

The commission recognizes that the issue of stranded costs is complex. In addition, the commission notes that the adjudication of this type of issue is largely dependent on the facts, circumstances, and remaining costs of a particular stranded project or equipment, and is not necessarily susceptible

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<sup>65</sup>Stipulation, at 6.



to meaningful review in a generic proceeding. Furthermore, given the commission's approval of the CHP Agreement herein, it appears that the stranded costs issue is moot with respect to the scope of this proceeding, as the Hotel will remain on-line as a MECO customer. Accordingly, the commission, at this time, declines to open a generic proceeding to examine the issue of stranded costs. Instead, the commission intends to address this type of issue if and when it arises in a specific general rate case proceeding.

F.

Project Reporting

In order to provide the commission and the Consumer Advocate with timely information on the CHP System, MECO, as part of its Application, proposes to file an annual status report by February 28 of each year of the CHP System operation that will include information on: (1) the CHP System heat rate, system availability and run hours and outage hours, and mode of operation; (2) estimated versus actual kW and kWh output of the CHP System generating units, and (3) estimated versus actual thermal output of the CHP System. MECO also proposes to provide an initial report comparing the estimated versus actual CHP System capital costs.<sup>66</sup>

The commission adopts as reasonable MECO's reporting proposals.

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<sup>66</sup>See also MECO's response to PUC-IR-105 (MECO confirms that its reporting proposals remain in effect, as part of the Parties' Stipulation).

#### IV.

##### Orders

###### THE COMMISSION ORDERS:

1. The Parties' intentional and voluntary waiver of an evidentiary hearing is approved.

2. The Parties' Stipulation, filed on November 9, 2007, is approved; provided that the commission declines to adopt the Parties' recommendation to open a generic proceeding to examine the issue of stranded costs.

3. The CHP Agreement, dated June 16, 2006, is approved.

4. MECO's request to include the incurred CHP System fuel costs, ground transportation costs, and related taxes, in MECO's Lanai Division's ECAC, to the extent that such costs are not included in MECO's base rates, and net of any decreases in other costs related to the CHP System and CHP Agreement that were included in MECO's last rate proceeding, is approved.

5. Within sixty days from the in-service date of the CHP System, MECO shall file an initial report comparing the estimated versus actual CHP System capital costs, with copies served on the Consumer Advocate.

6. MECO shall file an annual status report by February 28 of each year, with copies served on the Consumer Advocate, of the CHP System operation that will include information on: (A) the CHP System heat rate, system availability and run hours and outage hours, and mode of operation; (B) estimated versus actual kW and kWh output of the CHP System

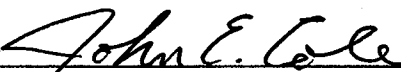
generating units, and (C) estimated versus actual thermal output of the CHP System. Unless ordered otherwise, the first annual status report shall be due by February 28, 2009.

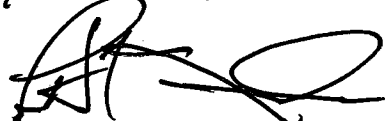
7. The failure to comply with Ordering Paragraphs No. 5 and No. 6, above, may constitute cause to void this Decision and Order, and may result in further regulatory action as authorized by State law.

DONE at Honolulu, Hawaii FEB 28 2008.


PUBLIC UTILITIES COMMISSION  
OF THE STATE OF HAWAII

By   
Carlito P. Caliboso, Chairman

By   
John E. Cole, Commissioner

By   
Leslie H. Kondo, Commissioner

APPROVED AS TO FORM:

  
Michael Azama  
Commission Counsel

2006-0186.laa

CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing Decision and Order No. 24058 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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Certificate of Service

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Karen Higashi

DATED: FEB 28 2008