

HECO Request for Proposals Renewable Energy Projects Financial Issues

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Hawaiian Electric Company, Inc.

Framework for Competitive Bidding

(D&O 23121 Docket No. 03-0372)

IV. The Request for Proposals Process

E. Bid Evaluation/Selection Criteria

6. In evaluating competing proposals, all relevant incremental costs to the electric utility and its ratepayers shall be considered (e.g., these may include transmission costs and system impacts, and the reasonably foreseeable balance sheet and related financial impacts of competing proposals).



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8. The impact of purchased power costs on the utility's balance sheets, and the potential for resulting utility credit downgrades (and higher borrowing costs), may be accounted for in the bid evaluation. Where the utility has to restructure its balance sheet and increase the percentage of more costly equity financing in order to offset the impacts of purchasing power on its balance sheet, this rebalancing cost shall also be taken into account in evaluating the total cost of a proposal for a new generating unit if IPP-owned, and it may be a requirement that bidders provide all information necessary to complete these evaluations. The RFP shall describe the methodology for considering financial effects.



HECO Has Experienced the Cost of Increasing Purchase Power Obligations

- As purchase power obligations have increased, HECO has had to increase the proportionate amount of equity in its capital structure
- Equity is higher cost than debt, therefore increase in purchase power obligations results in higher composite cost of capital which results in higher rates to ratepayers



History of Impact of Purchased Power Obligations on Credit Quality

- Late 1980's - 1990's: Large firm PPAs entered into
- Early 1990's: Credit rating agencies consider off-balance sheet payment obligations in evaluating financial strength, recognizing the shift in risks from IPPs to utility
- 2000/2001: California power crisis; Enron bankruptcy
- 2002-2003: New accounting standards; credit rating agency reassesses purchase power impact (assigned higher risk factor)
- 2007: Credit rating agency reassesses purchase power impact (refined risk factor assignments and expanded to include “all in” energy pricing)



Different Purchase Power Agreements

Different Accounting Treatments

Different Financial Implications

- Consolidation or
- Lease treatment or
- Purchase power agreement (off balance sheet with imputed debt treatment by credit rating agencies)



Consolidation Issues

- Financial Accounting Standards Board Interpretation No. 46R (“FIN 46 R”) “Consolidation of Variable Interest Entities (revised December 2003)”
- Test to determine if utility must consolidate financial statement of IPP on utility financial statement
 - Ownership NOT criteria for determining consolidation
 - Tests applied to certain contractual relationships including PPAs
 - Economic aspects of arrangement evaluated
- Utility must receive company-sensitive information
- Utility may have to consolidate IPP depending on risks absorbed by the PPA



Requirements to Address Consolidation Issues

4.3 Threshold Requirements

Variable Interest Entity Treatment

HECO is not willing to be subject to accounting treatment that results from variable interest entity (“VIE”) treatment as set forth in Financial Accounting Standards Board Interpretation No. 46 (revised December 2003) (“FIN 46R”). Bidders are required to demonstrate, with supporting information to allow the Company to verify such conclusion, that the proposal will not result in the seller under the power purchase agreement being a VIE that would trigger consolidation of seller’s financing on to HECO’s balance sheet under FIN 46R. If HECO believes that the proposal may be subject to such treatment, it will inform the Bidder and the IO and either may require additional information or work with the Bidder to structure the proposed power purchase agreement and/or generation entity to avoid VIE treatment.



Requirements to Address Consolidation Issues, cont.

- Model Purchase Power Agreement (Section 24)
Seller shall provide information for Company to comply with requirements of FIN46R
- May overlap with information requirements under Draft RFP, Appendix B, section 7 (Appendix B, pages B-33-34) Information required to demonstrate the financial viability of the project



Expected Accounting Treatment Based on Model PPA and Draft RFP Pricing

- Fixed Price (or fixed price with fixed escalation) per unit of output as required in the Draft RFP (Section 2.4) and other terms and conditions as specified in the Model PPA is expected to result in purchase power agreement being deemed not a lease
- Accounted for as a contract (off balance sheet with imputed debt treatment by credit rating agencies)



Imputed Debt

- Credit rating agencies impute debt for “off balance sheet” PPAs
 - Fixed payments or
 - “All in” payments
- Imputed debt impacts financial ratios used by credit rating agencies to evaluate financial risks of the utility
- In order to mitigate the impact of imputed debt, the Company has increased its equity percentage (and reduced its debt percentage) in its capital structure



Imputed Debt for “All In” Energy Pricing

Based on latest S&P methodology published (May 7, 2007):

- The pricing for some PPA contracts is stated as a single, all-in energy price. Standard & Poor’s considers an implied capacity price that funds the recovery of the supplier’s capital investment to be subsumed within the all-in energy price. Consequently, we use a proxy capacity charge, stated in \$/KW, to calculate an implied capacity payment associated with the PPA. The \$/KW figure is multiplied by the number of kilowatts under contract. In cases of resources such as wind power that exhibit very low capacity factors, we will adjust the kilowatts under contract to reflect the anticipated capacity factor that the resource is expected to achieve.
- We will employ a risk factor between the revised 25% risk factor for utilities with power cost adjustment mechanisms and 50%.



Imputed Debt for “All In” Energy Pricing Based on Latest S&P methodology

- Present value of implied capacity price * 25% risk factor
- Implied capacity price:
Proxy capacity charge * capacity * capacity factor
- Proxy capacity charge (\$/KW) based on new peaking capacity
- Anticipated capacity factor that the facility is expected to achieve



Estimated Rebalancing Costs Associated with Imputed Debt

- Cost of replacing “debt” with “composite (balanced) capital structure”
- Based on incremental composite cost of capital from latest interim or final rate case decision and order capital structure



Additional Sources of Background Information

- FIN 46 available at: www.fasb.org/st/#int46
- Accounting for purchase power contracts discussed in Docket No. 04-0365 Purchase Power Contract for As-Available Energy between Maui Electric Company, Limited and Kaheawa Wind Power, LLC, (December 16, 2003) Exhibit 8
- Imputed debt impacts discussed in Docket No. 03-0372 Competitive Bidding for New Generation Capacity see HECO Opening Brief (June 6, 2006) pp. 137-148
- Standard & Poor's RatingsDirect "Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements" dated May 17, 2007

