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London Economics International LLC

Future Electricity Sector Utility Ownership & Regulation in Hawaii

Draft Preliminary Results

Lanai island

Prepared for Hawaii Department of Business, Economic Development,
and Tourism (“DBEDT”)

Disclaimer notice

- ▶ **London Economics International LLC (“LEI”) was engaged by the Department of Business Economic Development and Tourism to look at various ownership and regulatory models for the State of Hawaii (also referred to herein as the “Project”). LEI has made the qualifications noted below with respect to the information contained in this preliminary presentation and the circumstances under which the presentation was prepared.**

- ▶ **While LEI has taken all reasonable care to ensure that its analysis is complete, power markets are highly dynamic, and thus certain recent developments may or may not be included in LEI’s analysis. Stakeholders should note that:**
 - LEI’s analysis is not intended to be a complete and exhaustive analysis of the Project. All possible factors of importance to a stakeholder have not necessarily been considered. The provision of an analysis by LEI does not obviate the need for the stakeholders to make further appropriate inquiries as to the accuracy of the information included therein, and to undertake their own analysis and due diligence.
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 - There can be substantial variation between assumptions and market outcomes analyzed by various consulting organizations specializing in power markets. LEI does not make any representation or warranty as to the consistency of LEI’s analysis with that of other parties.

The primary goals of today's outreach are to provide preliminary results and obtain final feedback from stakeholders

1 Provide an overview of analyses performed for the Study



2 Share insights on the preliminary results of the Study



3 Solicit stakeholders' input for the final report



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Regulatory models

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Summary of preliminary findings

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Q&A

DBEDT is directed by the legislation to:

Evaluate alternative utility ownership and regulatory models

Ownership models include: co-ops, investor-owned utilities, Single Buyer, and integrated distribution energy resources (“IDER”) system operator

Regulatory models include status quo with HERA, independent grid operator, distribution-focused regulatory model, and performance-based regulation

1

Assess the ability of each model to:

- 1) Achieve **state energy goals**
- 2) Maximize **customer cost savings**
- 3) Enable a **competitive distribution system**
- 4) Eliminate or reduce **conflicts of interest**
- 5) **Align interests**

2



Conduct a long-term cost benefit analysis

- **Costs** required to change from current model to new model
- **Legal and regulatory approvals** needed for the change
- Impact on **revenue requirements and rates**
- Effects on **distributed energy resources**

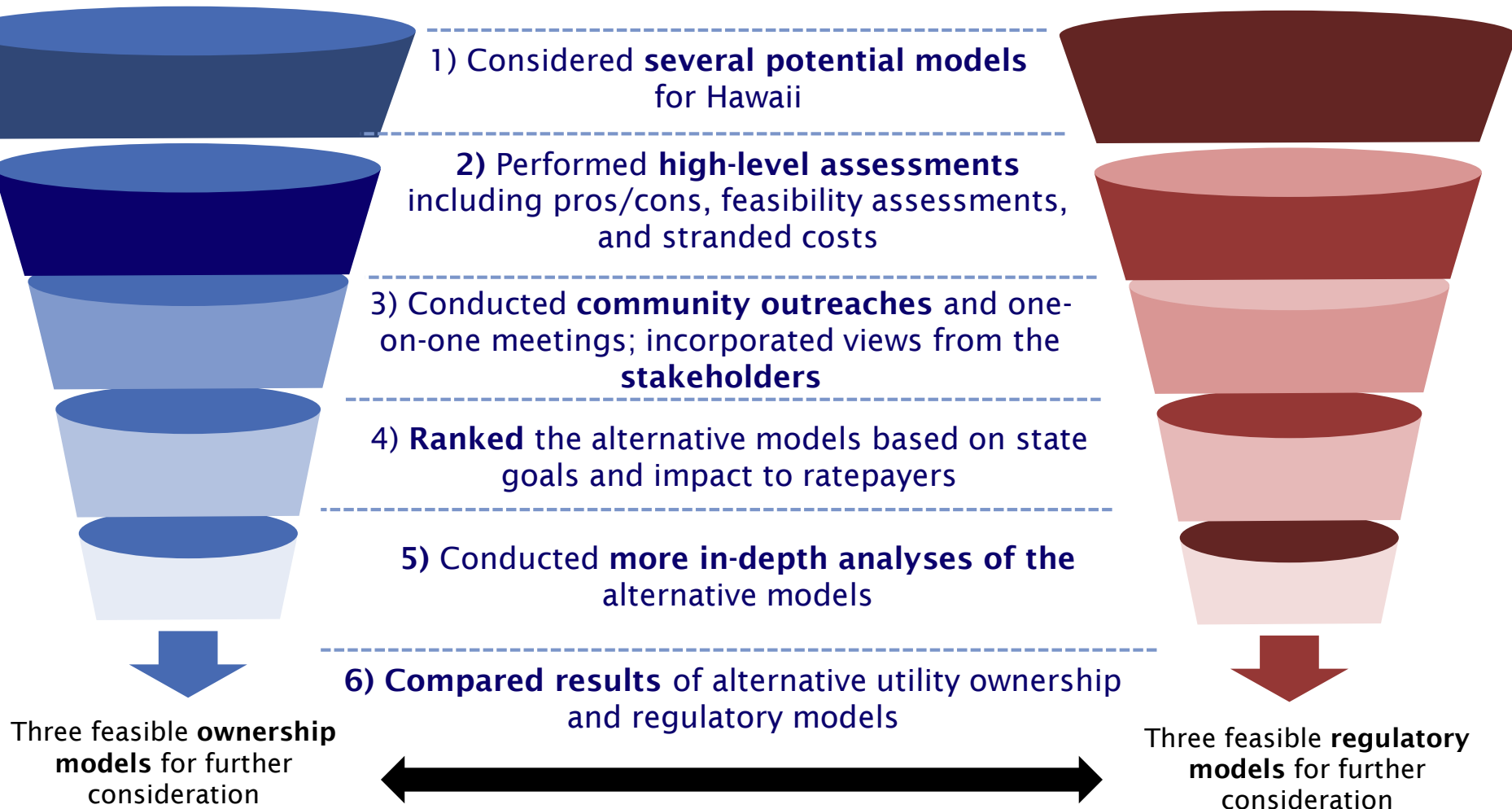
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The assessment of potential models consists of multiple layers, including various analyses and stakeholder outreaches

Ownership models

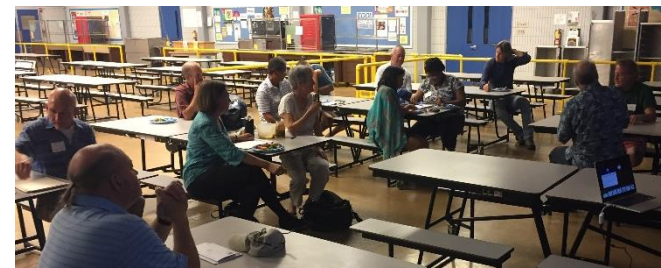
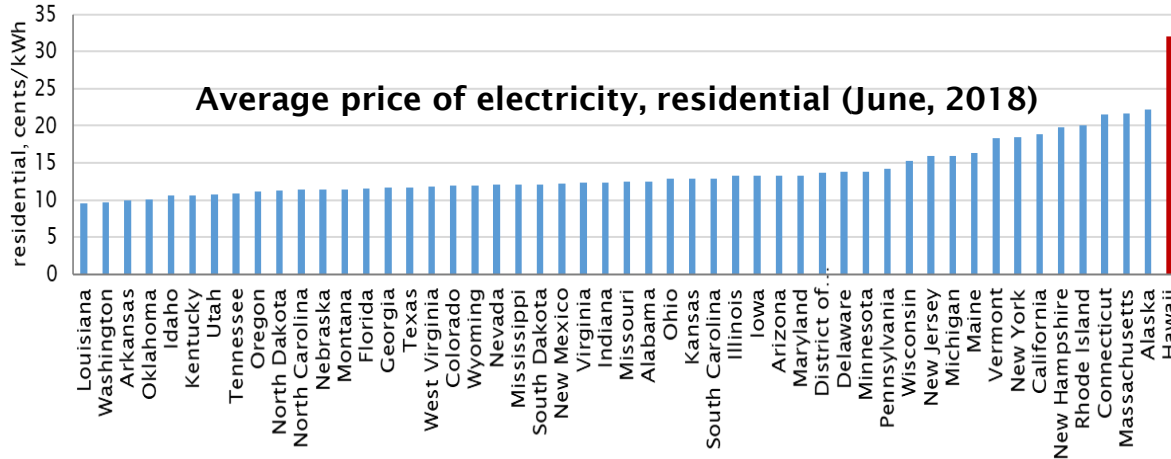
Key steps taken in the Study

Regulatory models



According to the stakeholders, lowering the rates now and in the future is a priority

Highest electricity prices in the country



Other priorities raised by stakeholders in Lanai *(not arranged in any particular order)*

- ▶ Infrastructure needs to be resilient and improved
- ▶ Local control
- ▶ More renewable energy
- ▶ Utility responsiveness to community needs
- ▶ Incorporate community inputs into decisions
- ▶ Any model must consider the costs

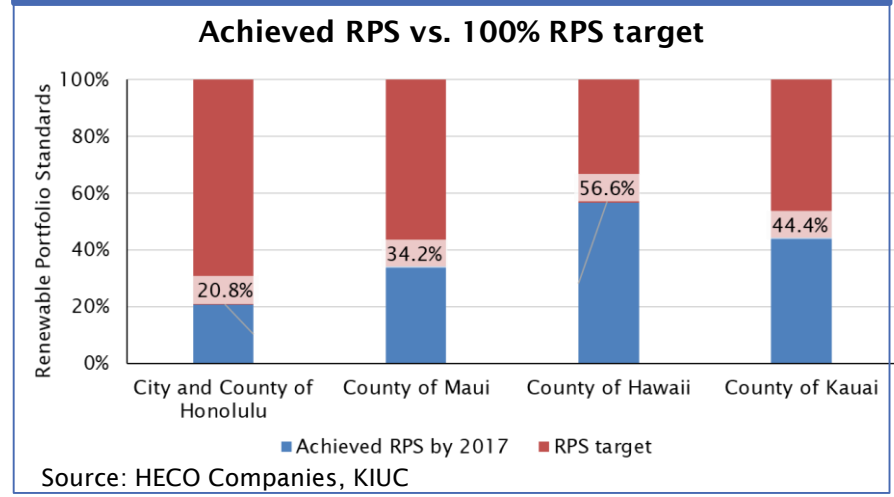


State's and counties' distinct characteristics are taken into account in the analyses

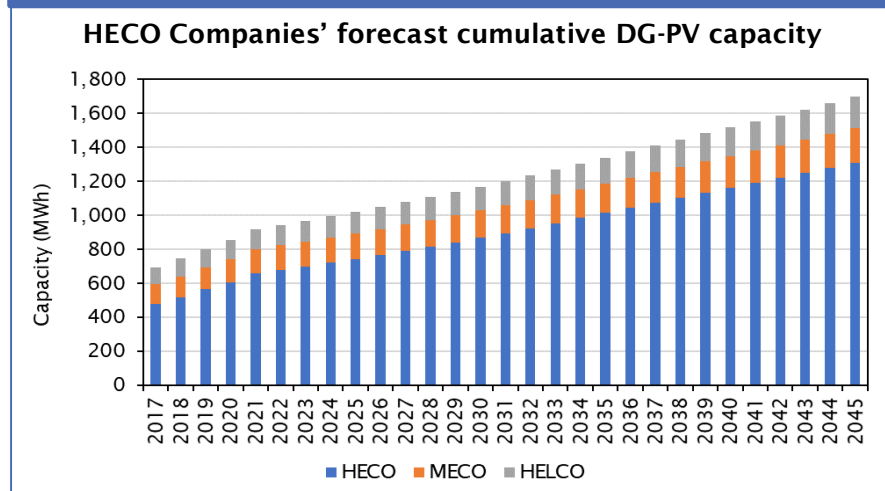
Comprise of islands



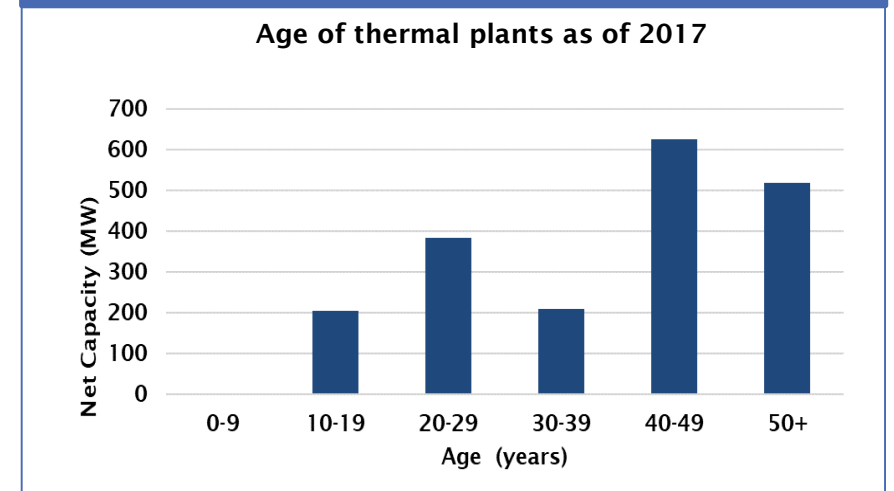
100% clean energy goal



Expected high proliferation of DERs



Aging generation and transmission assets



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Various utility ownership structures were reviewed including traditional utility-centric models to grid defection

| Model | Owner | How does it work? |
|---|--|--|
| 1) Investor-owned utility (“IOU”) | <ul style="list-style-type: none"> Shareholders (publicly traded or privately held) | <ul style="list-style-type: none"> Management is <i>appointed by the Board</i>, which has a fiduciary duty to its shareholders Can often <i>finance larger investments</i> than other types of utilities |
| 2) New parent | <ul style="list-style-type: none"> Private or not-for-profit | <ul style="list-style-type: none"> Could be <i>not-for-profit, a limited dividend, or a benefit corporation</i> Management is appointed by the Board |
| 3) Municipal utility (“muni”) | <ul style="list-style-type: none"> Owned by the city or the town | <ul style="list-style-type: none"> Governed by <i>local elected or appointed officials</i> Finance energy improvements with <i>government bonds</i> Benefit from access to <i>tax exempt debt financing</i> and they may also be tax exempt |
| 4) Cooperative (“co-op”) | <ul style="list-style-type: none"> Owned by the members-customers | <ul style="list-style-type: none"> Management has oversight by its <i>Board</i> and in some cases, from <i>regulators</i> have access to low cost debt and <i>special federal financing programs</i> |
| 5) Hybrid (majority government-owned) | <ul style="list-style-type: none"> Owned majority by the <i>government</i> | <ul style="list-style-type: none"> Management is appointed by the <i>Board</i> |
| 6) Integrated distributed energy resources (“IDER”) | <ul style="list-style-type: none"> <i>Utility</i> (wires assets) | <ul style="list-style-type: none"> Coordinating flows across the grid can either be done by the utility or another entity |
| 7) Single Buyer (“SB”) | <ul style="list-style-type: none"> Utility or independent, not-for-profit entity | <ul style="list-style-type: none"> SB within the utility is still owned by the utility but have stricter <i>ring-fencing mechanisms from other businesses</i> SB could also be outside the utility |
| 8) Grid defection | <ul style="list-style-type: none"> Diverse (generation) Utility (wires) | <ul style="list-style-type: none"> Utility would still provide services to customers connected to the grid but at a higher costs |

The “friendliness” of the acquisition plays a significant role in the feasibility of the ownership model

| Model | Stranded costs on generation? | Stranded costs on T&D? | Comply with reliability, adequacy, quality of service? | Require separation of some businesses? | Require costs to move to new model? | Require legal or regulatory changes? |
|---------------------|-------------------------------|------------------------|--|--|-------------------------------------|--------------------------------------|
| 1) Status quo (IOU) | | | | | | ✗ |
| 2) New parent | | | | | | ✗ |
| 3) Muni | ✗ | | | ✗ | | ✓ |
| 4) Co-op | | | | | | ✗ |
| 5) Hybrid | | ✗ | ✓ | | ✓ | |
| 6) IDER | | | | | | ✓ |
| 7) Single Buyer | ✗ | | | ✓ | | |
| 8) Grid defection | | | ✗ | ✗ | ✗ | ✗ |

 Positive
  Negative
  Can be positive or negative

“Ownership change will not entirely address our concerns; there is a need for regulatory changes and strong leadership” - Stakeholders

IOUs (Status quo)



- **Lack of competition**
- **Misalignment** between utility incentives and community interests or policy priorities

- **Stable**
- **Economies of scale**
- Can attract a **talented workforce**

Co-ops



- Concerns on the **acquisition costs**
- Sufficient staff resource on the islands with technical ability to manage the grid
- **Small population and 1 major owner**

- **Direct influence** on the decision-making process
- Serves the **needs of citizens** better
- Motivated to **drive down rates**

Munis



- **Politicization**
- Not interested because of **distrust in political leaders** and concerns about them managing a utility
- Issue on ability of government to **operate the utility**

- More **responsive** to community interests

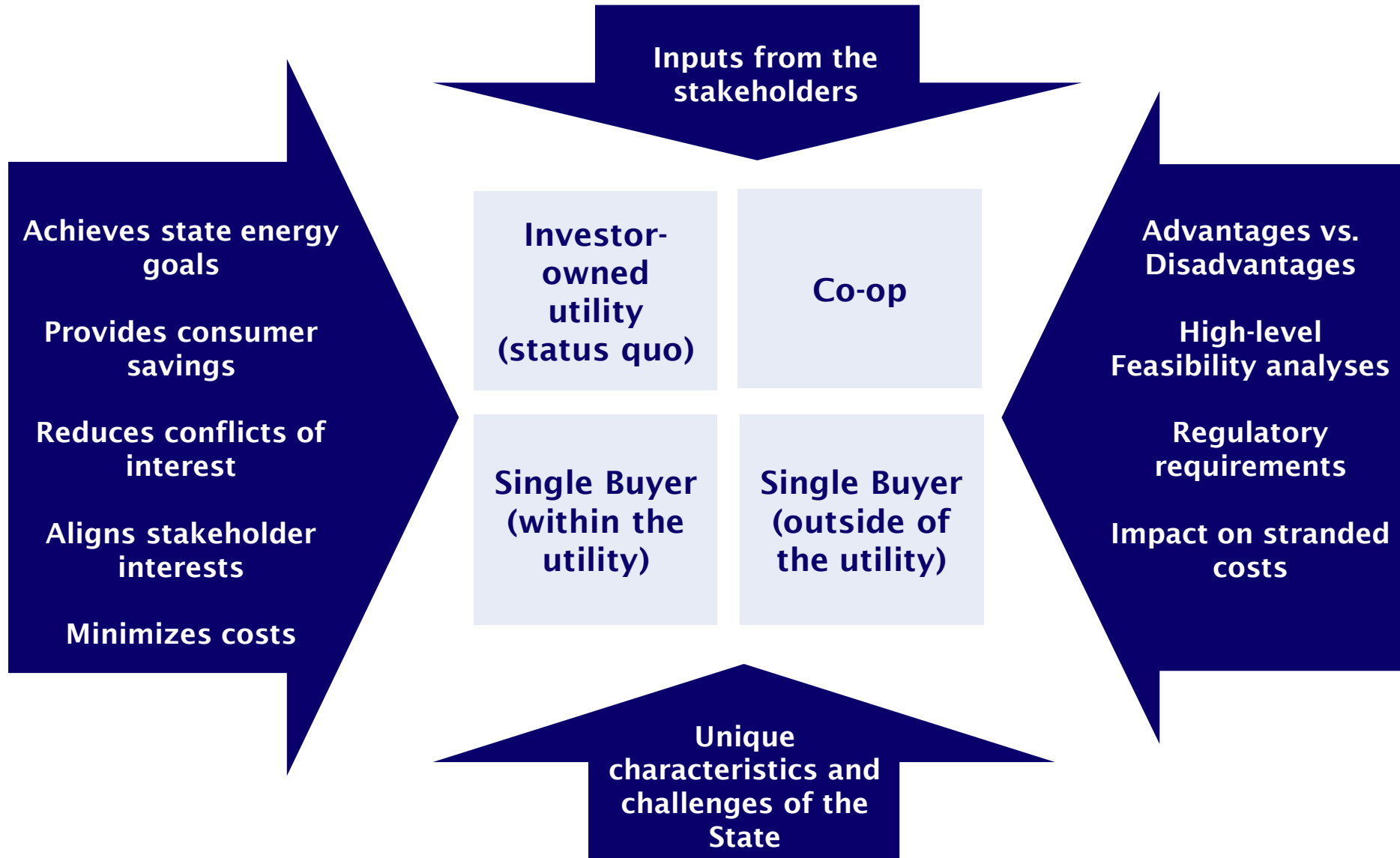
Wires (IDER and Single Buyer)



- **Complexity** of the model (IDER)
- **Limited** examples (Single Buyer)





- Ensures **fair procurement process**

Four ownership models, including IOU, co-op, and SB (within and outside of the utility) were selected for additional review











The SB approach is assumed to have lower cost than the co-op model, but the co-op model possesses greater certainty in implementation

| Models |  Investor-owned utilities Status quo |  Rural electric cooperatives Co-op |  Single Buyer (outside of the utility) |  Single Buyer (within the utility) |
|---------------|--|--|--|---|
| Costs | No costs | <ul style="list-style-type: none"> \$615 million to \$698 million (Maui County-wide) Transaction fees: \$6 million to \$14 million, depending on the size of the acquisition | <ul style="list-style-type: none"> Approximately \$2.9 million (Year One costs), which may be a low estimate of the total establishment cost | |
| Timeline | No steps | <ul style="list-style-type: none"> Approximately 24-36 months | <ul style="list-style-type: none"> 48 months, with significant uncertainty due to the legislative and regulatory processes to establish the single buyer entity | |
| Legal changes | No legal changes | <ul style="list-style-type: none"> No changes to regulation are necessary The burden of proof rests on the co-op to demonstrate that it can meet the laws and regulations already in place | <ul style="list-style-type: none"> Require a PUC proceeding | <ul style="list-style-type: none"> Requires legislative action to establish a new entity to undertake the planning and procurement responsibilities of the utility |

Implementing a Single Buyer model just for the island of Lanai would substantially increase rates on the island. Rates are expected to be slightly higher under a co-op model

Lanai

| Change of the Ownership Model | Model by island | | Model by County | |
|--|---|------------------|--|------------------|
| | Impact on rates* | Average impact** | Impact on rates* | Average impact** |
| Move to a co-op model |  | 1.9% |  | 1.7% |
| Move to a Single Buyer within the utility model |  | 29.6% |  | 0.8% |
| Move to a Single Buyer outside the utility model |  | 31.2% |  | 0.8% |

* Relative to the Status Quo

** From 2018 to 2045

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Discussions

Various regulatory models appropriate to the State and are not mutually exclusive were assessed

HERA Model

- ▶ A **dedicated body** (HERA) would enforce and oversee compliance with formal reliability standards
- ▶ HERA would **support the PUC** in carrying out critical functions related to reliability and grid access oversight functions
- ▶ The PUC may **contract** with a person, business, or organization, (but not a public utility) for the performance of HERA's functions

1

Distribution System Platform Provider ("DSSP")

- ▶ Distribution utilities are **required to provide a platform for third-party participation** in a distribution system marketplace
- ▶ Utilities would continue **own and operate** the distribution **system** and become the Distributed System Platform Provider ("DSPP")
- ▶ DSPP is **responsible for planning and designing its distribution system** to be able to integrate DER

3

Integrated Grid Operator Model ("IGO")

- ▶ An independent entity would be **responsible for planning and operations**, including the dispatch of both the transmission and distribution system
- ▶ IGO would also **determine the investment requirements** of both transmission and distribution networks
- ▶ Utilities would **continue to own** the wires assets, but the operations would be under the IGO

2

4

Performance-based regulation ("PBR")

- ▶ PBR **strengthens financial incentives to lower rates** and improve non-price performance
- ▶ It allows the adjustment of utility revenues **based on the utility's performance**



Three potential Hawaii-specific PBR options were identified based on the requirements of the Act and PUC goals

According to the PUC, the PBR should result in:

- 1** Greater *cost* control and reduced *rate volatility*
- 2** Efficient *investment and allocation of resources* regardless of classification as capital or operating expense
- 3** *Fair distribution of risks* between utilities and customers
- 4** Fulfillment of *State policy goals*


















| | Status quo | Light PBR | Conventional PBR | Outcomes-Based PBR |
|--|---|--|---|---|
| Features | Has some PBR mechanisms (<i>see below</i>) | Easier to implement given timeline set by the legislation | Going-in rates are set for the first year and increase in base rate would be based on <i>inflation less productivity</i> | Provides <i>flexibility</i> to the utilities on how to achieve the target outcomes |
| Term | 3 years | | | 5 years |
| Rate-setting approach | Cost of service | | Revenue cap using indexing formula | Revenue cap using building blocks approach |
| Performance incentives mechanisms ("PIM") | <ul style="list-style-type: none"> • Reliability • Cost savings in renewable generation procurement • Implementation of DR portfolio | <ul style="list-style-type: none"> • Outstanding performance would be rewarded while poor performance would be penalized • Expand current PIM list to include: availability, reliability, cost control, service quality, customer engagement, competitive procurement, RPS targets | Aligns with the target outcomes (e.g., enhance customer experience, improve utility performance, achieve public policies and goals, attain healthy financial performance) | |
| Earning sharing | Customers share the excess earnings like the current mechanism | | Customers share the earnings but sharing is symmetrical | |
| Treatment of capex and opex | Biased towards capital expenditures due to the revenue requirements formula | | No distinction between capital and operational expenditures (total expenditure approach or "totex") | |

Potential regulatory models are feasible, and some may require additional legislative processes

| Model | Result to stranded costs on generation? | Result to stranded costs on T&D? | Comply with reliability, adequacy, quality of service? | Entail the creation of a new entity to do a function of the utility or PUC? | Require costs to move to new model? | Require legal or regulatory changes? |
|---------|---|----------------------------------|--|---|-------------------------------------|--------------------------------------|
| 1) HERA | ✗ | ✗ | ✓ | ✓ | ✓ | ✗ |
| 2) IGO | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ |
| 3) DSPP | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ |
| 4) PBR | ✗ | ✗ | ✓ | ✗ | ✓ | ✗ |

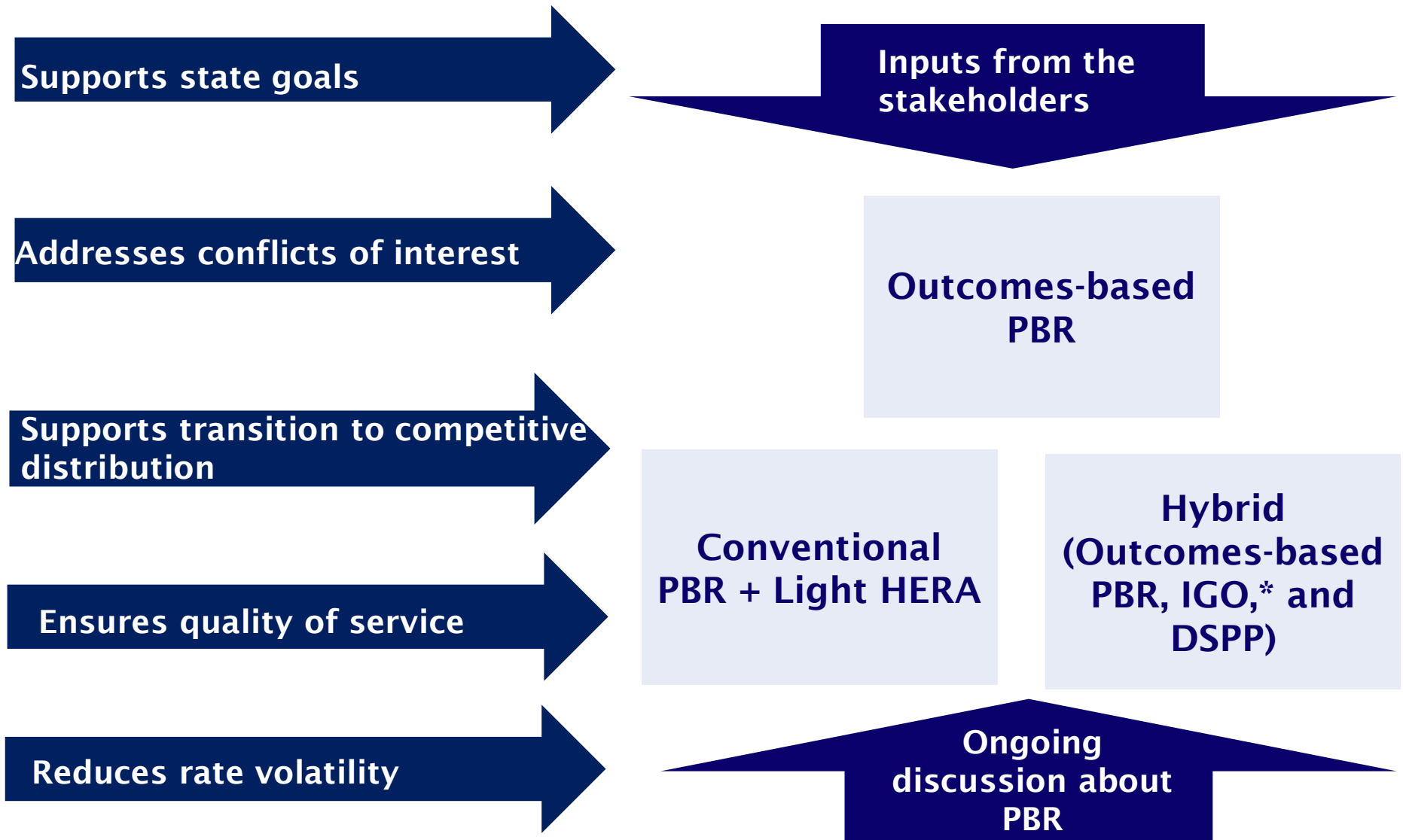
 Positive
 Negative

Stakeholders believe that there is a need to make changes to the current regulatory framework to achieve state goals

| Models | Positive | Negative |
|----------------------------|--|--|
| <p>1</p> <p>Status quo</p> | <p> Reliable electricity</p> <p> MECO maintains a personal relationship with the community</p> <p> Supportive of the PUC as it ensures utilities operate in the best interests of the citizens</p> | <p> not successful in lowering electric rates</p> <p> utility is not incentivized to take action or make investments in line with community priorities</p> <p> Consumer advocate does not accurately represent the interests of the Lanai community</p> |
| <p>2</p> <p>HERA</p> | <p> might increase grid access and increase deployment of renewables</p> | <p> would be redundant, since the PUC already assumes much of the role</p> <p> might increase costs</p> |
| <p>3</p> <p>IGO</p> | <p> would increase competition</p> | <p> would be too costly to implement</p> <p> the market is too small in Hawaii for an ISO to work</p> |
| <p>4</p> <p>DSPP</p> | <p> would increase competition and deployment of DERs</p> | <p> would not work in Hawaii as the cost would be too high</p> |
| <p>5</p> <p>PBR</p> | <p> Better than implementing a major overhaul of the current model Because you can incorporate performance metrics</p> | <p> would be difficult to design and implement PBR well</p> <p> It might be too risky</p> |



Analysis on the state criteria showed that combining some of the regulatory models would be more effective in facilitating the achievement of state goals



**IGO would only be created on Maui island if implemented separately for each island; on Lanai and Molokai, the Hybrid model would consist of Outcomes-based PBR and DSPP models.*



Costs and timeline for the proposed regulatory models increase with the complexity of the model, with Outcomes-based PBR requiring the least time and money







| Models | Status quo | Outcomes-based PBR | Conventional PBR + Light HERA | Hybrid |
|---------------|-------------------------------|--|---|---|
| Costs* | No significant cost increases | <ul style="list-style-type: none"> Higher PUC average annual expense during transition period; Total transition cost \$1M-\$2M (MECO county-wide) No long-term cost changes beyond transition | <ul style="list-style-type: none"> Conventional PBR: Higher PUC average annual expense during transition period, \$1M-\$2M total, no long-term change MECO county-wide) Light HERA: ~\$150k - \$200k start up cost and ~20% of that in annual funding MECO county-wide) | <ul style="list-style-type: none"> Outcomes-based PBR: Higher PUC average annual expense during transition period, \$1.3M total, IGO:\$3.3M in startup and annual operation costs MECO county-wide) DSPP: \$91M total implementation costs over 3-yr period MECO county-wide) |
| Timeline | No steps | <ul style="list-style-type: none"> ~21 months** | <ul style="list-style-type: none"> ~21 months for Conventional PBR** ~33 months for entire model | <ul style="list-style-type: none"> Outcomes-based PBR: ~21 months** IGO: 18-24 months (2023 target implementation) DSPP: 3+ years (2028 target implementation) |
| Legal changes | No legal changes | <ul style="list-style-type: none"> No legal changes needed because PBR falls under existing PUC legal authority | <ul style="list-style-type: none"> No legal changes needed for Conventional PBR No legal changes needed for Light HERA | <ul style="list-style-type: none"> No legal changes needed for Outcomes-based PBR Legislation likely required to authorize creation of IGO Legislation recommended to authorize creation of DSPP |

* Costs are Maui County-wide and allocated to each island based on current share of MECO's rate base

** January 1, 2020 is the deadline imposed by the State for PBR implementation. Although it is possible that the PUC meets this deadline, it is also possible that they will incur delays that lengthen the process)

Any change in regulatory models is expected to increase rates for Lanai's customers, if the change is implemented separately by island on Maui County

Lanai

| Change of the Regulatory Model | Model by island | | Model by County | |
|---|---|------------------|--|------------------|
| | Impact on rates* | Average impact** | Impact on rates* | Average impact** |
| Implement an Outcomes-based PBR model |  | 5.4% |  | -0.4% |
| Implement a Conventional PBR + Light HERA model |  | 6.6% |  | 2.2% |
| Implement a Hybrid model |  | 0.6% |  | -2.8% |

* Relative to the Status Quo

** From 2018 to 2045

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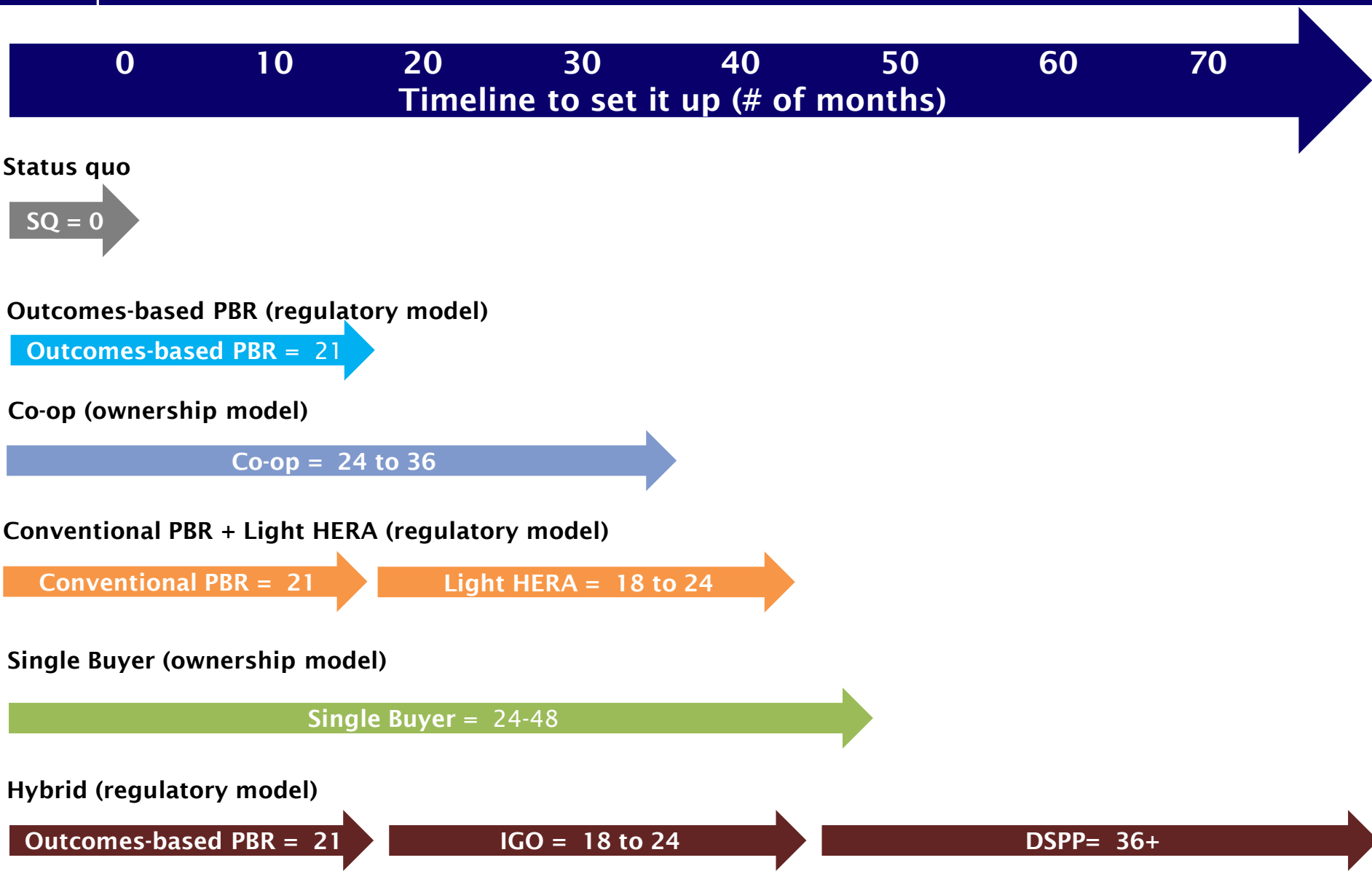
Summary of findings

5

Discussions



The more complex the model the longer it takes to set it up



Most of the ownership and regulatory models considered are already authorized and legal under Hawaii law

| | Models | Legal Changes Required? | Additional Information |
|-------------------|---|-------------------------|--|
| Ownership Models | Status Quo (IOU) | | No |
| | Co-op | No | <ul style="list-style-type: none"> Burden of proof rests on the co-op to demonstrate that it can meet the laws and regulations already in place |
| | Single Buyer | Yes | <ul style="list-style-type: none"> Legislative action is required to establish a new entity (for the “outside” SB model) to undertake planning and procurement responsibilities from the utility. |
| Regulatory Models | Status Quo (COS with some PBR mechanisms) | | No |
| | Outcomes-based PBR | No | <ul style="list-style-type: none"> No legal changes needed because PBR falls under existing PUC authority |
| | Conventional PBR + Light HERA | No | <ul style="list-style-type: none"> There is existing regulation already for both PBR and HERA |
| | Hybrid | Yes | <ul style="list-style-type: none"> Legislation needs to be enacted that authorizes and clarifies the DSPP PUC is not currently authorized to create an IGO, so legislation is needed for the PUC to create that entity |

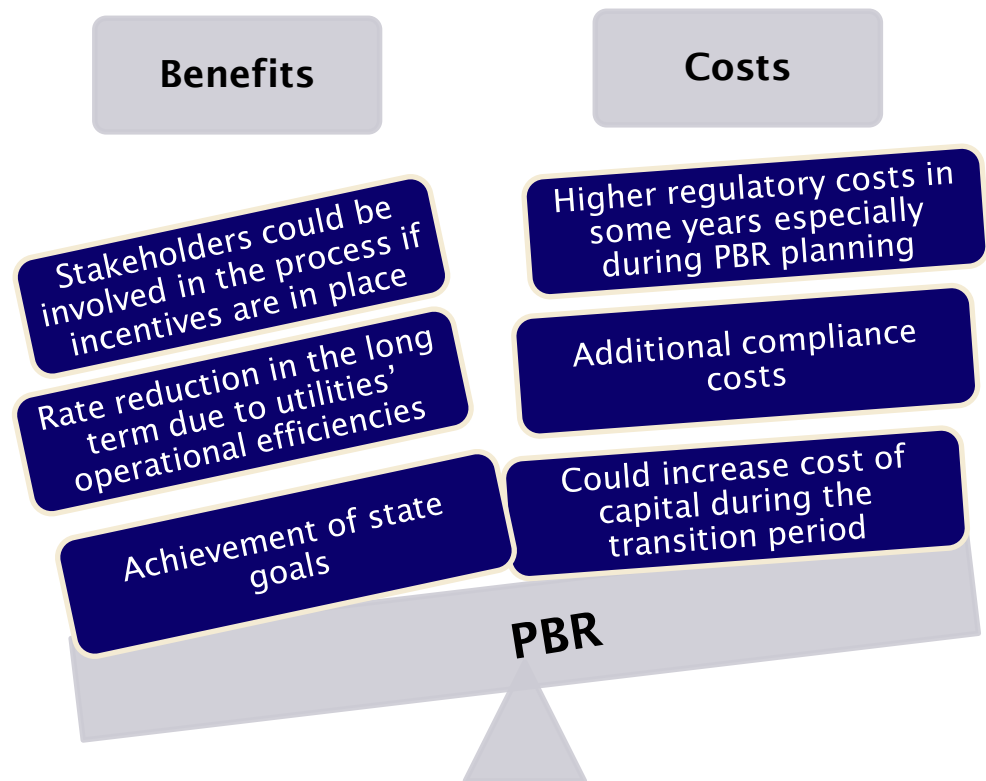
Changing either the ownership or the regulatory model only for the island of Lanai is expected to increase rates for customers

Lanai

| Change of the Ownership Model | Model by island | | Model by County | |
|--|-----------------|----------------|-----------------|----------------|
| | Impact on rates | Average impact | Impact on rates | Average impact |
| Move to a co-op model | ↑ | 1.9% | ↑ | 1.7% |
| Move to a Single Buyer within the utility model | ↑ | 29.6% | ↑ | 0.8% |
| Move to a Single Buyer outside the utility model | ↑ | 31.2% | ↑ | 0.8% |
| Change of the Regulatory Model | | | | |
| Implement an Outcomes-based PBR model | ↑ | 5.4% | ↓ | -0.4% |
| Implement a Conventional PBR + Light HERA model | ↑ | 6.6% | ↑ | 2.2% |
| Implement a Hybrid model | ↑ | 0.6% | ↓ | -2.8% |

Key conclusions

- ▶ The current ownership and regulatory framework has been *successful* at ensuring utilities *provide reliable service*
- ▶ A change in ownership model *does not necessarily address the #1 concern of the stakeholders*, which is to lower the electricity rates
 - In fact, a move to the co-op model or the Single Buyer models would likely be more expensive, especially if this is done separately for the island of Lanai
- ▶ On the other hand, a Hybrid model implemented throughout the Maui County would have *a greater impact in lowering the electricity rates* due to the PBR incentives and lower allocated costs for the IGO model
- ▶ Benefits of moving to an Outcomes-based PBR option (either standalone or hybrid) outweigh the costs in the long run
- ▶ Conventional PBR option is not suitable for Lanai because of expected decline of the utility's rate base on the island



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Group Discussion

► Guiding questions for small groups:

1. What do you think are the benefits and drawbacks of the seven alternative models?

2. Any other comments or concerns?

How to Engage

- ▶ **We encourage you to submit your feedback and input throughout the stakeholder engagement process:**
 - During the event, please fill out your worksheet to the best of your ability during discussion with your colleagues. After this event, we plan to collect your worksheets to gather input for our study.
 - We will also be available for feedback up to an hour after the event if you would like to provide additional comments.
 - You can also submit feedback via the following email:
dbedt.utilitybizmodstudy@hawaii.gov
 - Finally, the presentation will be available at:
<https://energy.hawaii.gov/community-outreach>

- ▶ **Questions? Concerns? Contact Us:**
 - Bridgett Neely, Bridgett@londoneconomics.com
 - Cherrylin Trinidad, cherrylin@londoneconomics.com
 - Utsav Adhikari, Utsav@londoneconomics.com