EXHIBIT A

Hawaiian Electric Company
Statement of Position
Competitive Bidding for New Generating Capacity in Hawaii
Docket No. 03-0372

Issue 1. What are the benefits and impacts of competitive bidding?

HECO/HELCO/MECO Position:

A. Competitive Bidding Process Must be Carefully Structured to Obtain the Potential Benefits

In the recent past, competitive bidding had become a fairly well-established means of procuring power supplies in some areas across the country. Prior to the move toward industry restructuring and retail access in the late 1990's, competitive bidding was required in over 30 states for utilities seeking new power supplies. While competitive bidding was once required in a large number of states, the advent of electric industry restructuring and retail access in a number of states has led to a reduction in the number of states that now require competitive bidding. However, several states have recently initiated competitive bidding programs (i.e., Louisiana, Florida, Utah and Arizona) or are considering reassessing bidding rules (i.e. Oregon). Thus, a number of competitive bidding processes have been documented and tested. Refer to Exhibit B for the Evolution of Competitive Bidding for New Generating Capacity, and to Exhibit E for the Competitive Bidding Status By State.

While competitive bidding has been widely implemented by utilities throughout the U.S. and Canada for the procurement of power supplies, the success of competitive bidding has varied. The development of a successful competitive bidding regime requires a significant degree of up-front planning, recognition of the potential advantages and pitfalls, resolution of potential pitfalls prior to initiating the competitive bidding process, and appropriate revisions to the regulatory structure to accommodate bidding. Not all competitive bidding programs have been successful in creating competition and leading to a reduction in cost to consumers. In fact, ineffective processes can discourage competition, lead to higher costs, reduce levels of electrical service reliability and set inefficient precedents for future power procurement processes. There are a number of potential pitfalls that could derail the implementation of an effective and successful process. These issues need to be addressed carefully before any consideration of competitive bidding for new generating capacity in Hawaii is approved.

B. Potential Benefits of Competitive Bidding

The potential benefits of competitive bidding include the following:

1. **Bidding has encouraged increased competition in some areas.**

   The response of bidders to competitive bidding processes has varied depending on the location, requirements of the soliciting utility, and cost to develop a project. For a number of processes, the ratio of bids received to MW solicited has averaged between 8-10 to 1. In active power markets, ratios in excess of 10 to 1 have not been uncommon.

   The HECO Companies caution that the response to a competitive bidding process in Hawaii will likely not achieve the same level of activity as on the mainland. This is due to the smaller capacity requirements in Hawaii, the lack of merchant plants seeking power contracts, lack of short-term options, and more limited market access. In addition, development costs are likely to be higher and economies of scale are not significant.

2. **Competitive bidding can promote an organized, structured process**

   An important benefit of competitive bidding is that all bidders and proposals participate in an organized, structured process. This is generally accomplished through a bidding process that requires all bids to be submitted at the same time, with all bidders providing complete and consistent information, with all bids being evaluated based on the same set of economic and fuel price assumptions, and with all bidders playing by the same set of rules. The evaluation of unsolicited proposals, such as traditional PURPA projects, can be complicated by different timing for proposal submission, and incomplete or inconsistent proposals.

3. **Bidding has often contributed to competitive prices and more choices**

   One of the primary goals of competitive bidding is to solicit and evaluate a wide range of resource options so that the best deals (among a range of options) for customers are selected.

   On the mainland, the overall experience with competitive bidding programs is that competition has led to a range of prices and products with the opportunity to select lower cost options. This has been due to several factors. First, the level of competition has generally been significant and has included a range of different product options. In addition, the recent glut in merchant power generation and the financial problems faced by a number of power generators are leading some project developers to lower their expected returns to compete. Second, in many RFPs there have been one or two bidders who aggressively price their product to compete or are uniquely positioned to offer lower prices. Competitive bidding can help identify such options. Third, Independent Power Producer ("IPP") generation contracts are generally performance-based contracts that require the generator to guarantee a minimum level of performance or be subject to penalties. IPPs may be more willing to accept provisions allocating more cost and

operational risks if they are bidding against other potential project developers. (However, they may seek "out" clauses if they are not able to pass the risks on to their contractors, or if their financing parties are unwilling to accept the risks.)

4. Bidding can encourage the development of new technologies and products

Effectively developed competitive bidding processes can encourage a wide range of options, including new technologies. Competitive bidding programs over the years have led to the selection of a wide range of resource options, rapid improvement of several generation technologies, enhanced market efficiencies, and creative project financial and contract structures.

While natural gas-fired combined cycle options have been the dominant form of capacity contracted through competitive bidding processes, other resources have been selected as well. Contracts for renewable resources have been increasing and many projects have been selected either through all supply source RFPs or targeted solicitations.

In addition, bidders have been very creative in structuring their proposals and attempting to distinguish their proposals from their competitors through any inherent competitive advantage gained through technology advantages, financing, fuel supply, operations and maintenance, or other unique capabilities or market niches.

5. Competitive bidding allows the host utility to clarify unique system characteristics in the RFP

Another advantage of competitive bidding is the ability of the host utility to include important and unique system requirements in the RFP. RFP documents generally contain a significant amount of information regarding the requirements of the utility, the resource attributes of importance to the utility, the criteria used for the evaluation, and other important criteria. For example, if the utility values dispatchability or other operating flexibility associated with a proposed unit, it could request that a bidder offer such an option and/or evaluate the impacts of dispatchability or operational flexibility in the bid evaluation process. Likewise, a well structured competitive bidding framework allows the utility to more effectively integrate a new unit into its system by valuing such factors as location, transmission access/cost of system upgrades, operational flexibility, financial impact, in-service date flexibility, and fuel supply access into the RFP and evaluation process. Thus, bidders can structure their proposals to meet the requirements of the buyer rather than submit unsolicited proposals without knowledge of the buyer's interest.

6. A properly structured competitive bidding process can limit self-dealing

In most RFP processes, the host utility plays a major role in the competitive bidding process including: (1) designing the RFP documents, evaluation criteria, and power purchase agreement; (2) managing the RFP process, including communications with bidders; (3) evaluating the bids received; (4) selecting the bids based on the established

criteria; (5) negotiating contracts with selected bidders; and (6) competing in the solicitation process with a self-build option, if feasible.

A 1996 study by the National Regulatory Research Institute (NRRI) entitled State Commission Regulation of Self-Dealing Power Transactions focused on issues associated with self-dealing and concluded that competitive bidding can limit self-dealing. The study also concluded that not allowing a utility bid or project to compete could eliminate the lowest cost and most viable option.

> If the host utility is prohibited from bidding, this clearly removes a significant opportunity for self-dealing. However, this also precludes the possibility that the utility may in fact be the lowest-cost and most viable provider. Also, having the utility as the provider carries the advantages of lower transactions costs and potentially better reliability assurance. There are also cost savings associated with the economies of scope and better integration of generating facilities to the transmission grid. Also, the host utility is usually subject to ex post prudence reviews that provide some protection against the utility's preferential treatment of itself over other suppliers (Page 33).

The "solution" has been to use an Independent Reviewer or Observer to monitor and report on the utility's conduct of its bidding process, evaluation of the bids, and selection of the winning bidder. This solution, however, can add to the cost of the process.

7. Competitive bidding can provide greater regulatory certainty

Conceptually, the selection of resources through a market test should serve to facilitate the regulatory process and alleviate the possibility for extended proceedings and the uncertainty associated with cost recovery and regulatory approvals. A well designed and implemented RFP process can minimize the risk of legal challenges to the results of the procurement process.

C. Potential Disadvantages of Competitive Bidding

While there are a number of advantages or benefits associated with competitive bidding there are also a number of potential disadvantages or major issues that must be recognized and addressed before a competitive bidding process can be effectively developed. These include:

1. Implementation of competitive bidding can lead to increased reliability risk

The isolated nature of the island's electrical system places a premium on reliability of power supply and increases the risk of project default and/or the failure of the independent generator to deliver the power. Unlike the mainland, Hawaii's electric utilities cannot resort to purchases of energy from the market during periods of generation shortfall if the project does not deliver the power as required under the contract. In many cases, project sponsors develop a proposal designed to win the

solicitation, but realize later that in attempting to compete, it has priced its power too low to remain economically viable. There have been a number of cases in which a bidder was either selected as the preferred project or actually signed a contract and failed to complete the project. In some cases, developers have been known to walk away from partially or nearly completed projects simply because the cost of completing the project and operating the facility were not economically viable. Delays in power plant development or the ultimate failure of a project to achieve commercial operations could have significant impacts on an island system.

In addition, increases in the penetration of non-utility resources could exacerbate reliability concerns if projects do not perform in accordance with their contracts during operations or new technologies introduce unintended consequences. While a competitive bidding system encourages lower cost bids, and the shifting of risk to project sponsors, incentives to lower cost could lead to poor operating performance or project failure if the bidder has not effectively managed risk.

The presence of a Power Purchase Agreement ("PPA") between the utility and an IPP does not provide the utility with as much operating flexibility as the utility has with its own units. While the PPA can specify operating conditions favorable to the utility (such as coordination of maintenance, dispatchability, etc.), the utility generally has less control over plant maintenance practices, operational considerations, fuel conversion opportunities, and environmental enhancements. In contrast, the utility has such operating flexibility with its own units.

Utilities have the obligation to serve their customers while Independent Power Producers ("IPPs") who supply capacity and energy to the utilities under PPAs may be obligated to provide to the utility only those items and services, or to perform only those duties, that are covered by provisions in the PPA. At times, this can constrain the utility's operating flexibility. The following examples illustrate how the utilities operating flexibility can be constrained by IPPs.

- An IPP may be reluctant to increase its expenses in order to hasten a return from a planned maintenance outage to accommodate the utility's need for capacity at a particular time.

- An IPP that is capable of providing more capacity than it is obligated to under the terms of the PPA may limit the output of its facilities to the grid, even though the utility may have a need for the capacity at a particular time. The utility would need to rely on persuasion and cooperation arising from good business relationships in order to obtain anything beyond the terms of the PPA.

- IPPs are dispatched based on PPA pricing provisions, which often contain pricing curves. If it turns out that the pricing curves do not actually track the IPP's costs, then the IPPs will seek to be dispatched (and will exercise their rights under the

PPA) so as to maximize their profitability (taking into account differences between their prices and costs), not to minimize the utility's costs.

- An IPP may refuse to operate during certain periods of the week because it is more economical to pay a penalty according to the PPA for being unavailable than to operate.

- An IPP may be experiencing frequent forced outages, which may result in service interruptions to utility customers. Yet the utility only has a limited amount of latitude under most PPAs to require evaluations of the IPPs power plant configuration, and to design and specify improvements to reduce the number of forced outages.

- Many IPP units are designed, built, owned and operated by mainland- or foreign-based corporations who may not fully understand the intricacies of operating small, isolated, non-interconnected island grids. Often they do not comprehend the relative impact of their generation on these smaller isolated grids, and may resist operating under system conditions such as low frequency, low voltage, high frequency or high voltage under which utility units have to operate under system contingency conditions. The result is a higher potential for grid instability.

IPPs do not have the same "obligation to serve" that the utility does, and their performance is not subject to regulatory review. IPPs generally will make decisions on whether or not to provide capacity or energy based on economics, and not on the potential impact of their decisions on the utility's customers. When customers experience a service interruption that is based on a shortfall of generation, the customers look to the utility, not the IPP, as the cause.

Although PPAs are written with care and are improved upon with every new PPA that is negotiated, every PPA is subject to interpretation. The IPP will interpret the contract to its advantage, which can lead to disputes, which can be costly to resolve.

A utility has much more flexibility to adjust to changed circumstances if it owns and operates it own units, than if it purchases power under long-term PPAs, because PPAs cannot be drafted to provide for all future contingencies and changed circumstances.

When building and operating its own unit, the utility can make changes in the operation of the unit and can modify the unit when appropriate, which cannot necessarily be done with purchased power under a PPA. For example, the utility generally will have more flexibility to accelerate or defer the in-service dates of its own units and to change the manner in which its own units are operated, and to adjust the maintenance schedules and the manning of its own units.

In the case of a change that requires the amendment of a PPA, the approval of the amendment generally will have to be negotiated with the IPP's owners (which may be a

partnership or limited partnership), the IPP's lenders (which may be a group of lenders), and possibly even with certain suppliers under long-term contracts with the IPP; all of whom are represented by counsel.[1]

The interests of the utility, its customers and its shareholders are aligned because the utility's goal is to provide reliable service at the lowest reasonable cost to its customers while still earning a fair return on investment, based on the risks assumed in investing in the plant and rate base necessary to provide such service. The utility's decision to make or not make changes in its operations or facilities to adjust to changing circumstances would be subject to Commission review.

An IPP's decision to reject a request to change its PPA would not be subject to Commission review. Thus, the success of negotiations to amend a PPA will depend on the terms of the PPA and the economic impact of the modifications on the individual interests of the entities with an interest in a PPA, not the benefit of the amendment to the utility's customers.

The PPA's inherent lack of flexibility becomes magnified as the term of the contract is extended. This occurs because the assumptions used in negotiating the PPA become less precise as the period being forecasted increases. To the extent that these assumptions do not accurately predict future circumstances, any inflexibility inherently caused by the legal obligation of a long-term contract or by specific contract terms based on those set of assumptions would tend to be magnified.

The ability of an IPP to respond to the utility's needs would be governed by the terms and conditions of the PPA. The only way to provide the PPA with flexibility to adjust to all potential changed circumstances would be to grant the utility the right to act unilaterally to serve its own interests, provided that the facility was not damaged by the utility's actions. To the extent that an IPP is unwilling to grant the utility such rights under a PPA, the utility's flexibility would be diminished.

Project failure, termination of a project, or poor operating performance could be particularly detrimental in Hawaii since back-up resources are not readily available. Since the utility will still have the obligation to serve, project failures could be detrimental from both a reliability and cost standpoint.

While it could be argued that liquidated damages and security requirements in the power contract could serve to compensate the utility for the cost of replacement power if the project sponsor fails to deliver, financial coverage of this risk is not adequate in Hawaii. Instead, the utility requires physical power supply and the ensured ability of the generator to deliver capacity and energy.

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[1] These approvals are in addition to approval from the Commission, which may also apply to changes in utility facilities requiring capital expenditures.

The risk of project failure and reliability concerns will likely result in maintaining the requirement for parallel planning and close coordination between a utility and developer to ensure an IPP project meets its milestones will be required. The first notice of failure to meet the milestone schedule may result in a triggering of a parallel planning process and a back-up supply plan should the project fail.

Reliability concerns should lead to more stringent security provisions and higher bidder qualification standards to ensure the bidder has the incentive to meet its obligations under the contract. The need to ensure reliability through more stringent contract terms may mean that some resource options may have difficulty in competing.

2. The development and implementation of an effective competitive bidding process can be very time consuming

An effective competitive bidding process can take a substantial amount of time to develop and implement. A three to four year time horizon from development of the competitive bidding procedures to development and issuance of the RFP, and to negotiation and approval of a contract with a selected bidder is not unusual. This limits the flexibility of the host utility to solicit for resources quickly if requirements change. It should be noted, however, that current IRP process and negotiations/discussions for unsolicited QF proposals are time consuming as well.

It took nearly two years to develop the bidding rules in Oregon, from initiation of the case through a series of workshops to the establishment of rules. Recently, Louisiana initiated a proceeding to deal with market test rules for new generation. The Commission asked the Staff to open a Docket in December 2001. An Order was issued in the case establishing the rules in January 2004, more that two years later. The experiences in other states have been similar, particularly in cases where the new bidding rules have to be integrated with existing statutes.

The time required to undertake a competitive bidding process can be lengthy as well. Portland General Electric filed its Integrated Resource Plan in August 2002 and its draft RFP in April 2003. The RFP was issued in June 2003. Contract negotiations were recently completed (December 2004). In another recent RFP case, the Georgia Public Service Commission recently issued new bidding rules through a revision of the IRP rules in Georgia. Georgia Power and Savannah Electric are expected to issue RFPs for power supplies in January of 2005. According to the schedule identified by the Commission staff, the process is expected to take nearly two years from issuance of the RFP until Commission approval of the contracts resulting from the process. Furthermore, this schedule does not even include the time required to develop the RFP for the first solicitation process.

Because of the length of time needed to develop and implement a well-designed competitive bidding process, certain utility capacity addition projects already under development should not be subject to the competitive bidding process. For example,

HECO currently has an urgent need for firm generating capacity. (Please refer to HECO's Adequacy of Supply report, filed with the PUC on March 10, 2005.) Efforts to install a simple cycle peaking unit at Campbell Industrial Park have been under way since early 2003. Although the capacity to be provided by the unit is needed now, the unit is not expected to be installed sooner than 2009, because of the long lead time for environmental review, permitting and approvals, equipment procurement and construction. It would not be practical for this unit to be subject to competitive bidding, because a well-designed and effective competitive bidding process cannot be put into place and completed soon enough. Based on the experiences in other states, it may take two years or more to develop the bidding rules. Once the rules are established, it may take two years or more to prepare an RFP, solicit proposals, evaluate the proposal, select the winning bidder and negotiate a contract. It could then take another seven years for the utility to obtain approval of the contract, and the selected bidder to obtain the necessary permits, procure the necessary equipment, and construct the unit. The unit would not be installed until several years beyond 2009.

On Maui, MECO is already procuring equipment for Maalaea Unit M18, which is scheduled for commercial operation in 2006. It would not be practical to subject this unit to a competitive bidding process as development of the project is well under way. In addition, MECO is already undertaking the permitting process for the first increment of firm generating capacity at its Waena site (Waena Unit 1), which is scheduled for installation in the 2010 timeframe. The unit may be needed sooner if the actual peak reduction benefits of MECO's proposed load management demand-side management ("DSM") and Combined Heat and Power ("CHP") projects are significantly lower than forecasted. (Please refer to MECO's Adequacy of Supply report to be filed no later than March 15, 2005.) It would not be practical to subject this unit to competitive bidding, because of the length of time it would take for bidding rules to be established and for the actual competitive bidding process to take place.

On the Island of Hawaii, Keahole Unit ST-7 is scheduled for installation in 2009 or sooner. Permitting efforts are already under way pursuant to a Settlement Agreement. It would not be practical to subject this unit to competitive bidding because of the length of time it would take for bidding rules to be established and for the actual competitive bidding process to take place.

3. The resource commitment and cost to the host utility and regulators to undertake a competitive bidding process can be very substantial

The development and implementation of a competitive bidding program will require significant resources of the host utility and can be expensive to implement. For example, in undertaking a competitive bidding process, utilities generally establish several internal project teams for the price analysis, non-price analysis and contract negotiations. This usually requires several analysts to undertake the pricing assessment as well as representatives from a number of departments within the Company to undertake the non-price analysis (e.g. financial analysis, environmental analysis, fuels, engineering,

transmission system analysis, operations, siting/land, and legal). If the utility is proposing a self-build option, available resources may be further limited to protect confidentiality or outside resources may be required. In any case, the cost and commitment of resources is significant. Small utilities, such as HECO, may be particularly constrained in their ability to dedicate the appropriate amount of resources to adequately staff the project teams required. In other words, there are not enough people with the specialized skills to divide into the specific functions needed to carry out bidding and evaluation responsibilities, while at the same time being excluded from carrying out their planning and evaluation responsibilities with respect to the utility's own projects. Such a resource problem has existed for larger utilities, such as Portland General Electric, which presented a challenge for dedicating the required level of staff to the process.

Also, in some cases the utility is required to select an Independent Reviewer or Observer to observe or review the bidding process. This cost could be quite high as well. For example, it was reported in a recent bidding process on the mainland that the cost of the Independent Observer exceeded $500,000. HECO's competitive bidding consultant is aware of another competitive bidding process where the cost of the Independent Observer was approximately $1 million.

One of the lessons learned in undertaking a competitive bidding process for the first time is that the utility generally underestimates the resources, time required to undertake the RFP process, and the cost for undertaking the process, particularly the bid evaluation and contract negotiation phases.

The development and administration of competitive bidding processes will also place a significant burden on the Public Utilities Commission (PUC) and its staff, and the Consumer Advocate and its staff, to monitor and review the process, in addition to reviewing and approving the outcome of the process.

4. Implementation of a competitive bidding process can result in elimination of certain resources that may be favored from a public policy perspective

A strict implementation of competitive bidding may result in the elimination of less economical but publicly desirable resources competing on an equal footing with more economic options. For example, in many jurisdictions gas-fired combined cycle plants have been the lowest cost options in most RFP processes due to the low capital cost costs of these units, efficient heat rates, standardized unit design, flexibility in operations and shorter lead-time for development. Renewable projects such as wind, photovoltaics, biomass and landfill gas, and even other fossil fuel technologies such as coal, have had difficulty competing against gas-fired combined cycle projects in an all supply source RFP. Bidding programs designed to enhance the benefits of one resource relative to another may be contrary to the intent of the competitive bidding process and may result in a conflict with other public policy goals.

5. While mainland competitive bidding processes provide valuable models, one size does not fit all

The needs of isolated utility systems in Hawaii are significantly different from the utility systems on the mainland, which could influence the design and development of a competitive bidding process and the associated rules and guidelines. In many areas of the U.S. mainland, utility systems are part of a larger regional market, which provides utilities with access to a range of power supply options and products and reduces reliability risk. (In a number of instances, these include existing Merchant plants.) In these systems, failure of the supplier to deliver could result in the buyer being indemnified based on the financial penalties contained in the power purchase agreement. The financial nature of the contract provides the utility the opportunity to purchase replacement power at market prices. The seller has to compensate the utility the difference between the contract price and the market price. The utility is made financially whole and still has access to reliable power supplies in the broader market.

In an isolated power market such as Hawaii, the inability to procure other sources of power could be devastating. There is no "broader market" from which replacement power could be obtained. The utility needs the physical power to meet customer reliability requirements. It is irrelevant if the utility is made financially whole.

Furthermore, purchased power already plays a significant role in the power market in Hawaii. The impact of additional purchased power on the reliability and operating flexibility of the power system in Hawaii would have to be addressed in any competitive bidding process.

To gain a better perspective on the unique nature of the Hawaiian electric system relative to mainland systems, the major characteristics of each system are contrasted below.

- Given the interconnected nature of utilities in many regions of the mainland, product and resource diversity is generally greater and a portfolio of resource options, contract terms, and product types is more likely. By contrast, it is expected that the number of options in Hawaii will be limited to new, long-term resource options. Resource and contract diversity options may also be more limited since options such as merchant generation, short-term contracts with marketers, and flexible products are not available in Hawaii. Suppliers will not build excess capacity and will insist on long-term contracts since there is no alternative market for the power. While suppliers on the mainland could offer a shorter-term contact and wheel the power to a broader market after the contract terminates, this option is not reasonable in Hawaii, with no alternative market. Suppliers have a limited outlet and, therefore, will seek longer term contracts. The utility will also need assurance of a long-term source of supply, especially given the long lead time needed for development or replacement resources.

- Given the size of the utility systems on each Island and the expected level of load growth, the amount of capacity required via a competitive bidding process is likely to be for a smaller amount of capacity than is traditionally required on the mainland, where it is not uncommon for utilities to request between 500 and 1,000 MW per solicitation. As a result, there may be fewer competitors to supply the power required, since most project developers prefer to construct larger units (as development costs are usually similar no matter the size of the project). Also, since economies of scale are common with larger projects, developers prefer to construct larger units and spread the development costs over more megawatts.

- Unlike mainland systems, there are no transmission interconnections between islands that allow for larger scale projects and broader market access. As a result, each island will have its unique needs and will place different values on resource options.

- HECO already relies on non-utility generation to meet a significant portion of its power supply requirements. This indicates that a viable non-utility market is already effectively present. Also, the financial impacts on the utility's balance sheet associated with increased purchased power costs will likely be more of a financial risk to HECO than most mainland utilities with a lower reliance on long-term purchased power arrangements. The power purchase contracts between HECO and independent generators are long-term in nature and are exclusive with HECO, leading to long-term risk to the buyer. In fact, HECO is one utility that has already been required by rating agencies to rebalance its balance sheet by adding more equity to offset inferred debt from long-term purchased power agreements.

	2004 IPP Capacity as a Percent of Firm Capacity	2004 IPP Generation as a Percent of Total Net-to-System Generation	2004 IPP Capacity as a Percent of Firm Capacity	2006 IPP Generation as a Percent of Total Net-to-System Generation
Oahu	25%	39%	26%	42%
Maui	6%	7%	6%	16%

- System reliability and resource availability are very important in Hawaii given the isolated nature of the utility system in Hawaii. Contract provisions will need to reflect this requirement. The reliability of specific generation resources in interconnected systems may not be as important as in isolated systems. Power contracts have become more focused on financial arrangements with liquidated damages paid to the buyer in case of default designed to keep the buyer

financially whole. As a result, if a seller defaults, the buyer merely collects the damages and buys the make-up power in the market. For utilities in Hawaii, contract provisions will be more stringent, and financial damages will not make the utility and its customers "whole" if generation shortfalls result.

- By the nature of the island energy system, fuel options are more limited in Hawaii than on the mainland. In particular, there are no natural gas sources, unlike on most mainland systems where natural gas-fired projects dominate. Also, on the mainland, many utilities are offering gas tolling options to power generators[2], thereby absorbing the fuel risk. This is possible since the utility may also have a portfolio of gas supply contracts and transportation arrangements.

- The unique operational characteristics associated with the electric system in Hawaii would have to be accounted for in any competitive bidding process. These include the unique considerations and operational aspects of isolated utility system (i.e., plant size limitations, quick start capability, spinning reserves, quick-load pick-up capability, minimum load requirements, reliability requirements, cycling requirements, redundancy, frequency and voltage control, system frequency bias, and other factors), load growth uncertainty, land use restrictions, and permitting requirements.

- Economies of scale and scope are more important competitive factors in the mainland markets and the development schedule will likely be much shorter than in Hawaii.

- Due to the nature of the power system in Hawaii with no outside interconnections and available options, HECO may be required to undertake a parallel planning process in case a selected project fails.

- Capacity installation costs are higher in Hawaii. The costs of developing new generating resources in Hawaii that can meet the unique requirements to operate in a non-interconnected island grid are invariably underestimated by those relying upon cost estimates for similar resources to be installed on the mainland. Moreover, the costs tend to be site-specific. Only the developers with acquired sites would be able to submit realistic bids, and those who bid based on mainland-derived cost estimates (who might well be the low bidders) would not be able to finance or build their proposed projects.

[2] In such a tolling arrangement, the utility purchases and supplies the fuel.

6. **Competitive Bidding and procurement of power resources through IPP power purchase agreements may reduce the utility's ability to manage the unique grid requirements of isolated utility systems**

   Contractual arrangements for the purchase of power may sometimes constrain the flexibility to manage system issues that evolve over time. Modifications to generating units needed to meet new operating requirements, such as cycling on and off or being operated at lower load levels, may be difficult to obtain. Project financing agreements may limit the ability of the IPP to agree to modifications, even if the utility compensates the IPP for making the modifications.

7. **Competitive bidding and procurement through independent power purchase agreements may reduce utility and regulatory control over utility system operations.**

   The PUC can not exercise the same level of regulatory control over IPPs that it has over the utility. In particular, the PUC does not generally have access to the financial information of IPPs or control over their profitability to ensure that the utility system customers receive an adequate benefit for the power being purchased. As the level of power purchased from IPPs increases, the PUC must increase reliance on the utility's ability to manage the IPP performance through the terms and conditions of its contracts.

8. **Various forms of competition already exist that can achieve the goals of competitive bidding**

   IPPs already have the opportunity to propose projects that can deliver power at less than the costs of the utility's alternatives. This is evidenced by the fact that there are already significant IPP levels of penetration on the HECO systems.

   The utilities already use competitive bidding processes for equipment and service procurement to ensure cost management.

   Utility customers are continuously looking for ways to reduce costs. Competitive alternatives already exist from many kinds of self-generation (distributed) resource providers, including renewable technologies such as photovoltaics, fuel cells, and combined heat and power (CHP) facilities.

Issue 2: Whether a competitive bidding system should be developed for acquiring or building new generation in Hawaii?

HECO/HELCO/MECO Position:

A. HECO has Concerns with Competitive Bidding

HECO has reservations about the effectiveness of competitive bidding in an island system such as Hawaii. If competitive bidding is implemented, there are a number of potential shortcomings or pitfalls that need to be addressed to ensure that a competitive bidding system provides benefits to customers and shareholders. HECO can appreciate some of the potential benefits of competitive bidding but supports the implementation of competitive bidding only if the process is designed in such a way that the benefits occur instead of the pitfalls.

B. Potential Shortcomings of Competitive Bidding that Need to be Addressed

The following are the potential pitfalls or shortcomings that need to be satisfactorily addressed:

1. **The time allotted for developing and implementing a competitive bidding process must be adequate to ensure all the key potential pitfalls and shortcomings are appropriately addressed. While the process can be time consuming, HECO advocates taking the necessary time up-front to effectively design the rules and guidelines necessary to implement the competitive bidding process including the power purchase contracts**

The development and implementation of a competitive bidding process can be a very time consuming process, generally taking several years to complete. However, taking the time necessary to effectively develop the process in the early stages serves to avoid the potential for very costly mistakes and potential delays later in the process.

There are several approaches for instituting competitive bidding as evidenced by the experiences in other states:

(1) a common approach followed by a number of states is to adopt the rules and guidelines for competitive bidding first through a formal regulatory process (e.g. Competitive Bidding Docket), prior to initiation of the actual competitive solicitation. Under this approach, the soliciting utility and bidders know the rules and guidelines and the process is implemented based on these guidelines. In a number of jurisdictions, the bidding guidelines were integrated with the state statutes underlying how jurisdictional utilities are regulated in the state.

(2) another approach is to develop the bidding procedures and RFP via a collaborative process, with input from a number of parties. One of the disadvantages of collaborative processes is that they tend to take longer and often result in less than optimum compromises to resolve issues put forth by special

interest groups. However, collaborative processes could be used whether formal bidding rules are in place or not. For example, the Oregon Public Utilities Commission established the bidding rules in 1991. The recent Portland General RFP process followed the bidding rules but the IRP and RFP were undertaken via a collaborative type process.

(3) a third approach is for the soliciting utility to independently develop and issue an RFP when it needs power and evaluate the bids when received. The rules and guidelines for the process are established in the RFP, generally without input from outside entities.

There are trade-offs associated with each approach. In the latter approach, the utility has the discretion to carry out the bidding process and select the appropriate proposal. This approach can be implemented quickly when the need arises. However, it is possible that bidder complaints and problems will arise, because certain bidders may claim they were not being fairly treated or the process was biased toward a specific type of bidder or project structure. It is not uncommon for bidders to file complaints with the public utility commission if a bidder loses or feels it needs additional time to complete its proposal.

The approach based on the establishment of bidding rules and guidelines followed by the issuance of an RFP has been more common. Bidding rules and guidelines exist in a number of states and other states are in the process of implementing such rules. (Please refer to Exhibit E for the Competitive Bidding Status By State.) This approach also provides clearer signals to bidders and others in terms of the specific rules of the game and the guidelines under which the competitive bidding process will be conducted. With clear rules in place, there should be fewer complaints by bidders and less uncertainty about the process. While this approach may limit flexibility in terms of adjusting to changing market conditions, the guidelines could be developed to offer some opportunity to adjust the process to conform to required changes.

This approach can be time consuming, but it is important to spend the needed time up-front in the development of the bidding rules and guidelines (and the integration with the IRP framework) to address the potential shortcomings and pitfalls of a competitive bidding process and avoid difficulties later on. As noted before, it is not uncommon for the process from development of the bidding guidelines to implementation of the competitive bidding process to take several years. In addition, this process will require significant regulatory involvement throughout the process.

One of the major complexities often overlooked in competitive bidding processes is the development of the power purchase agreements which ultimately specify the terms and conditions of products and services being bid. Power purchase contracts developed prior to the bidding process can help to organize and structure the process by specifying the terms and conditions to which all bidders must conform. A major difficulty is developing a contract document that can accommodate varying types of technologies and

performance criteria. For example, firm power purchase contracts must have many more specific performance and enforcement provisions than as-available energy contracts.

HECO's position is that the process to develop an effective and fair competitive bidding process will be time consuming. However, it is important that sufficient time be allocated to ensure the process is adequately developed and potential pitfalls and shortcomings can be discussed and resolved.

2. A competitive bidding process should be integrated with the Integrated Resource Planning process already in place

Hawaii has a well established integrated resource planning process in place that would need to be revised to accommodate competitive bidding (see response to Question 6). In many jurisdictions, utilities have used the IRP process to provide strategic direction to the long-term resource acquisition process. The IRP has been used to determine the portfolio strategy of the utility (i.e. level of renewable resources desired, fuel diversity requirements, environmental attributes, etc.), identify the timing and amount of capacity needs, and the preferred technologies or resources based on an assessment of the estimated costs of potential resource options. The results and findings from the IRP process can provide the necessary inputs to the development and implementation of the RFP. Thus, in many jurisdictions, there is a close linkage between the IRP process and the RFP.

In a number of jurisdictions, the integration of the two may require revisions to the IRP rules or even the statutes under which the utility operates within the state. HECO believes the two processes should be integrated and it is necessary to decide on the appropriate integration option before competitive bidding is implemented in Hawaii.

There are several methods for conducting the IRP and competitive bidding process. The first option and the most common is to implement the competitive bidding process after the IRP process is initiated and a preliminary "preferred" plan is developed (see Figure 1). The IRP can be performed using the current process followed by HECO. In this case, the role of the IRP is to identify the preliminary "preferred" resource plan, define capacity and energy requirements, the timing of need, any preferred technologies, and potentially any other preferred attributes. The IRP can also be used to identify any preferences or criteria for resource selection and can be used to determine avoided costs.

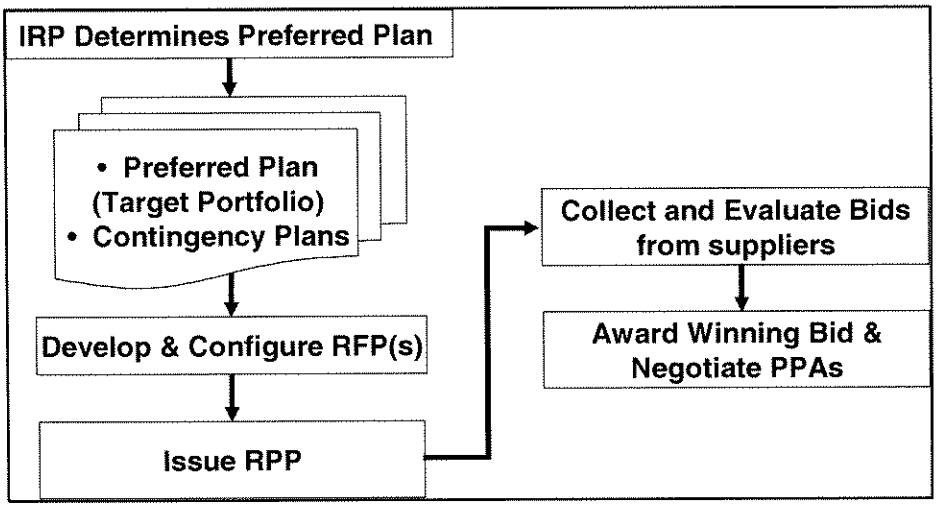

Figure 1: Preliminary IRP Followed by RFP Process and Resource Selection

In this model, the role of the RFP includes the solicitation and evaluation of resource options to meet the capacity and energy needs identified in the preliminary resource plan. The RFP can be used to solicit bids for either a block of resources as defined in the IRP or for the next required resource identified in the IRP. Bidders are allowed to submit proposals for any variety of resource types and sizes. The utility also has the right to submit proposals for resources that may differ from the preferred resource type included in the preliminary resource plan. The bids received in response to the RFP are evaluated relative to one another and/or to the avoided costs of the generic resource identified in the IRP or to the utility self-build project. The IRP establishes the parameters for the RFP. After the bids are evaluated and the preferred resource selected, the utility will then build the resource (if a self-build option is selected), or negotiate a turnkey contract or power purchase agreement (PPA) with the winning bidder (if a turnkey or PPA option is selected). HECO will essentially develop its preferred resource plan after the bids are received. The final bid(s) selected will be part of the final integrated resource plan.

The advantages of this approach are that the final Integrated Resource Plan is developed after the bids are received and evaluated, and the resulting resource(s) has been subjected to a competitive market test. Also, this approach allows for the opportunity to develop a portfolio of projects to include in the final resource plan.

One drawback is that developers may not want to bid resources identified as preferred in the later years of the resource plan, because they do not represent current business opportunities, which would limit the validation of cost estimates by market test. However, the utility will not want to irrevocably lock itself into commitments for resources that will not be needed for many years anyway.

In Hawaii, the preferred utility strategy is one that allows the utility to make major decisions regarding the implementation of program options (for both supply-side and demand-side resources) incrementally, based on the best available information at the time decisions must be made. The "Preferred" Plan is better characterized as a planning "strategy", rather than a fixed course of action. The plan identifies what information is critical to the decision making process, and also identifies when the strategic decision needs to be made. A critical element of the plan is the recognition that the planned generating additions can be altered as the utility pursues other options, including renewable technologies and additional cost-effective DSM programs. This planning strategy allows the development of alternate options to address alternate futures. In order to retain flexibility:

- IRP preliminary preferred plan would be created to provide a benchmark against which resources can be evaluated. Resource plans would be compared using the resource-in/resource-out method, with the preferred plan as the basis. Refer to Appendix B in the HECO Companies Electric Utility System Cost System filing (Avoided Cost Methodology).

- An evaluation of bids submitted in a competitive bidding process may reveal that the most cost-effective unit is not necessarily a unit that is in the IRP preferred plan. Weight must be given to the factors that led to a particular resource being included in the preferred plan. For example, if a coal unit is in the preferred plan to provide a fuel diversity benefit even if it is not the most cost-effective resource, then the bid evaluation must give weight to resources that provide a fuel diversity benefit.

- The IRP preferred plan will define resources that were selected based on assumptions that were applicable at the time the plan was selected. However, actual conditions can deviate from the assumptions upon which the preferred plan was selected. Bids must be evaluated on the basis of actual conditions at the time the bids are evaluated. Give example.]

- Bidding would be conducted for near-term needs, taking into account the time required to permit and install the resources.

A second option is to perform competitive bidding within the IRP cycle simultaneously (see Figure 2). Under this approach, the IRP determines the need for capacity and the timing of need. The RFP is developed and issued during the IRP cycle. Basically, the integration phase of the IRP occurs with the evaluation phase of the RFP. The bids received are "run" through the IRP process like any generic unit or utility option. The IRP is based on the evaluation of the bids with a preferred plan and contingency plan identified. Contracts are negotiated with the winning bidders.

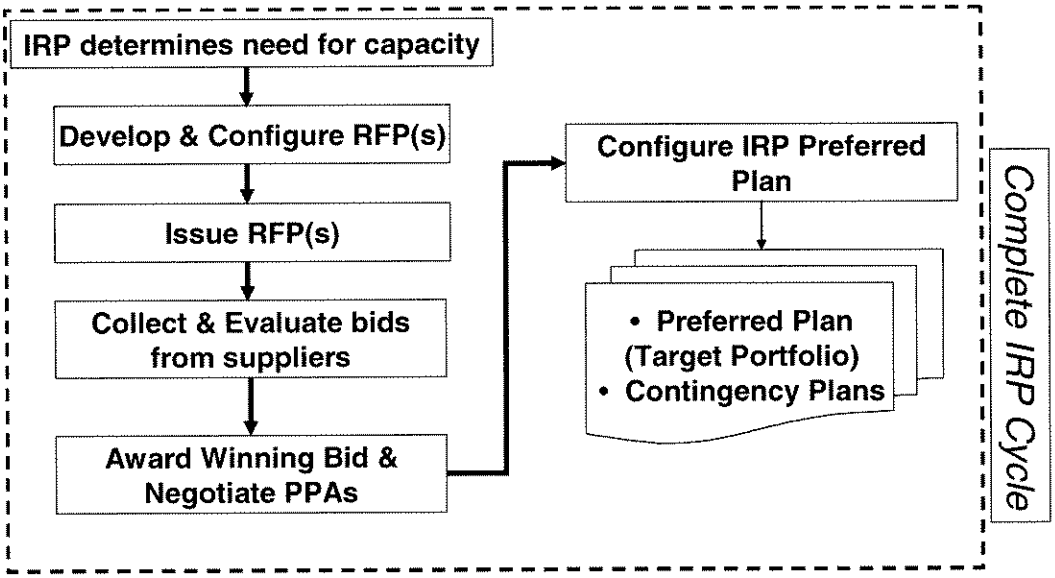

Figure 2: RFP Performed as Part of IRP Process

The advantage of this approach is that the bids are used to develop the preferred resource plan. However, developers may be unwilling to participate at an early stage in the process, or to freeze prices for the time required to complete the IRP process. While some developers may be willing to submit preliminary bids, they may not be meaningful and could be used to "game" the process since they will not be bidding. Such an approach limits the effectiveness of the IRP Advisory Group, who are exposed to confidentiality issues and disclosure issues associated with potential access to competitive intelligence in the RFP process. This approach is not typical of recent competitive bidding approaches.

A third approach is to perform competitive bidding independent of the IRP process. This approach is more consistent with a targeted solicitation process, in many cases designed to meet a regulatory initiative such as the renewable portfolio standard. Renewable resource RFPs may be initiated outside the IRP cycle.

If it is determined that competitive bidding processes should go forward, the first approach is probably the most practical for Hawaii. The IRP process is well established with a role defined for the Advisory Group and other stakeholders. The RFP process can be reasonably integrated with this process. While the time requirements to undertake both processes will extend the period for the IRP process, all resource options will be identified and evaluated under the same evaluation criteria and framework.

3. The host utility as a primary stakeholder must play a major role in the competitive bidding process

The host utility should play a major role in the competitive bidding process including: (1) designing the RFP documents, evaluation criteria, and power purchase agreement; (2) managing the RFP process, including communications with bidders; (3) evaluating the bids received; (4) selecting the bids based on the established criteria; (5) negotiating contracts with selected bidders; and (6) competing in the solicitation process with a self-build option, if feasible.

The above mentioned roles for the host utility are common in most RFP processes and are recognized by regulators and third-party bidders as a reasonable role for the host utility. Recent competitive bidding dockets have recognized the role of the utility and have supported an active role for the host utility. In fact, in several recent RFP processes, utility self-build or turnkey options have been the successful bidders among a large number of options, including recent Portland General Electric, PacifiCorp and Florida Power & Light RFP processes.

The goal of any competitive bidding process is to encourage and evaluate a range of generation options with the objective of obtaining the best possible option for the customers of the utility. This goal can only be assured if all resource options are allowed to compete. Regulatory commissions have recognized that a utility project may be the lowest cost option and failure to allow that option to compete may result in higher cost power options, contrary to their goals and objectives.

In two recent competitive bidding proposals, these issues were clearly addressed. The Staff Report and Recommendations prepared by the Staff of the Louisiana Public Service Commission in Docket No. R-26172 (Development of Market-Based Mechanisms to Evaluate Proposals to Construct or Acquire Generating Capacity to Meet Native Load), March 13, 2002, clearly stated its objectives in considering the competitive bidding process.

> As many of the comments correctly recognize, the utilities have an obligation to serve and provide reliable service. They also have an obligation to do so at lowest reasonable cost. This rulemaking does not change those basic principles. Given this obligation, along with episodic problems in recent years associated with wholesale market supply (e.g. price spikes, shortages), the self-build option cannot be "taken off the table" in deference to the market. Moreover, the maintenance of a self-build option for utilities will help serve to discipline and restrain the market in the intermediate and long run. (Page 4)

Comments of bidders regarding utility participation in the RFP process were summarized in the Order:

> Most commenters, however, recognized that utility projects may be appropriate if they pass a market test. As Sempra's witness states, the purpose of the RFP process is to "get the best deal for ratepayers in terms of cost, risks, reliability and environmental performance". It is possible that a utility self-build project -- vetted through an RFP -- could be the "best deal for ratepayers." (Page 3 of Commission Order)

In its Order, the Louisiana Public Service Commission identified the role of the utility in the competitive bidding process as follows:

> After providing an opportunity for review, analysis and comment on the planning data and the draft RFP, the utility will proceed with the issuance of the RFP and review of the bids received. Staff and qualifying participants (those entitled to review the confidential bids) will have an opportunity to review the bids and the utility's evaluation analysis of those bids. Based upon the RFP results and its evaluation, the utility may choose to proceed with its self-build option or enter into contract negotiations with one or more bidders (or both). Staff (and qualified participants) will have the opportunity to provide input on the utility's bid evaluation and resource selection. (Page 5 of the Commission's Order, Feb. 16, 2004)

Likewise, the Staff Report prepared by the Staff of the Arizona Public Service Commission (Competitive Solicitation Docket NOS E-00000A-02-0051 ET AL), October 25, 2002 concluded:

> The utility will be responsible for preparing the solicitation and conducting the solicitation process. Acquisition of energy and capacity to meet the needs of customers remains the responsibility of the utility, and the utility shall use accepted business standards for acquiring these resources, as it does when it buys all other products used in providing service. (Page 8)

In other recent RFP processes, self-build options have been allowed and encouraged. For example, the Oregon Public Utility Commission allowed Portland General to offer a self-build option as a result of a revision to its 1991 competitive bidding rules, which stated that utility self-build options were not eligible to bid. Portland General had to submit its proposal to the Commission in advance of receipt of other bids and had to provide the same information required of other bidders.

The bidding rules in Quebec allow Hydro-Quebec Generation to bid into the Distribution Company's Call for Tenders process as long as everyone abides by the same rules. The Generation Company has been awarded contacts but other independent power producers have been successful bidders as well.

Furthermore, the utility possesses the models and methodologies to undertake the most comprehensive evaluation of the bids received, and also significant knowledge and information regarding its system and customers. This information and capability ensures that the most detailed and comprehensive analysis can be undertaken.

With regard to host utility self-build options, as previously noted, utilities have been selecting their own build options more frequently over the past few years for several reasons. First, the financial and credit problems faced by independent generators have led to higher debt costs and higher equity ratios for independent generators, virtually eliminating the competitive advantage once enjoyed by independent generators. Utility projects are now competitive from a financial perspective. Second, transmission constraints in a number of markets have led to higher transmission costs for resources located outside the utility service area or in costly transmission areas. Third, the deteriorating credit quality of many independent generators has raised concern over counter-party reliability. In turn, power purchase agreements require higher levels of security and tighter damage provisions to protect the utility's customers against the prospect of contract default. There is heightened concern that independent generators are less reliable that host utilities in developing and operating their projects.

4. The competitive bidding process should take into account all costs associated with each bid to ensure all bids are fairly and equitably evaluated

For a competitive bidding process to be fair and equitable, all relevant costs should be recognized for each bid, in addition to the direct cost of the bid itself. This includes the transmission costs and system impacts associated with each project, **system operational impacts**, and the impacts of purchased power on the utility's balance sheet.

Including the impacts on the transmission system for each bid (or each short-listed bid) is common in most RFPs. Utilities generally conduct interconnection studies that assess the direct cost of interconnecting the plant to the utility system as well as the cost of any transmission system upgrades to effectuate delivery of power to the customers. In several recent RFPs, these costs have been significant and a major influence on the relative ranking of each bid.

The impact of each bid on system operations can be addressed through a system-wide evaluation which considers the impact of each bid based on the operating flexibility included in the proposal. The economic evaluation can be based on the system-wide net present value revenue requirements for each resource plan or portfolio with the bids included in each plan. For example, if a bidder offers dispatchability of its unit, the avoided costs or incremental costs associated with unit dispatch can be calculated and included in system-wide costs. Likewise, if a project is bid as a "must run" unit, the impacts of that operational mode on system costs should be calculated and included in the evaluation. In this case, if the project is designed to operate whenever it is available, it may displace lower fuel cost units or result in other units being dispatched off-line or not

operating. These units may be required to provide voltage support or other system benefits that now are more costly to provide or result in unintended system constraints.

Another important cost component and one that is gaining attention on the mainland is the impact of purchased power costs on the utilities' balance sheets and the potential for utility credit downgrades (and higher borrowing costs) as a result.

Basically, rating agencies treat the fixed payments associated with power purchase agreements as debt on the utility's balance sheet since the utility has incurred an obligation to make a stream of fixed payments to the seller over the life of the contract. Imputing or including the cost of purchased power as debt has the potential of adversely affecting a utility's capital structure and its interest coverage ratios due to this increased risk. A corresponding increase in the equity of the utility may be required to rebalance the capital structure and this cost needs to be accounted for in evaluating power purchase agreements. Because the cost of equity exceeds the cost of debt, this rebalancing of the utility's capital structure to accommodate the additional financial leverage of purchased power contracts imposes additional costs that must be considered in any economic evaluation of alternatives. As a result, while purchased power commitments do not involve direct capital investment, they do have financial implications that must be considered to allow for a meaningful comparison between supply alternatives.

While recent accounting rules have affirmed how such costs should be treated, it is important to note that the HECO Companies have already been required by the credit rating agencies to rebalance their capital structures as a result of their purchased power commitments. The HECO Companies have had to add higher cost equity capital to balance the imputed debt attributed to existing non-utility power purchase agreements.

In 2003, the United States Emerging Issues Task Force (EITF) reached a consensus on EITF Issue 01-8 whereby "arrangements or contracts that traditionally have not been viewed as leases may contain features that would require them to be accounted for as leases under Financial Accounting Standard 13, Accounting for Leases". Examples of arrangements that may fall under these rules include power purchase agreements. Under these rules, if the purchased power agreement meets the tests included in EITF 01-8 for lease accounting and the tests for a capital lease included in FAS 13 the transaction is explicitly recorded as a debt obligation on the utility's balance sheet. The accounting for capital lease obligations is not a discretionary issue and as noted the HECO Companies have had to abide by these rules. Please refer to Exhibit C for a detailed discussion of the accounting issues.

Several states have approved the inclusion of direct or imputed debt associated with purchased power commitments in the evaluation of resource options. For example, Florida utilities have included an equity adjustment in their RFP process. Also, the Florida Public Service Commission has acknowledged that an equity adjustment is appropriate to address the capital structure impacts associated with purchase power arrangements and it is reasonable to consider the financial impacts of purchased power.

The Florida Commission determined that purchased power contracts imply higher debt leverage, and that the costs of rebalancing the capital structure to accommodate this debt should be considered in determining payments for purchased power. Other states such as Wisconsin, Utah, California, and Oregon have recently raised the issue for consideration of resource options. The Wisconsin Public Service Commission concluded that the utility must be compensated for the adverse impact on its capitalization associated with capital lease obligations arising from purchased power transactions.

The California Public Utilities Commission stated in Decision 04-12-048 (Order Instituting Rulemaking to Promote Policy and Program Coordination and Integration in Electric Utility Resource Planning, December 16, 2004):

> Debt Equivalence is a real cost that needs to be considered when evaluating bids from a PPA vs. a utility-owned resource. As SDG&E states, "[I]t is essentially undisputed that the credit analysts treat the utilities' long-term non-debt obligations, such as PPAs, as if they are in fact debt when they assess a utility's debt capacity." Consequently, the IOUs should take into account the impact of Debt Equivalence when evaluating individual bids in an all-source and RPS RFO, regardless of whether it is a fossil, renewable, or an existing QF resource. (Page 144)

Based on the HECO Companies' already significant commitment to purchased power and the requirement already imposed on the company to rebalance its balance sheet as a result of these obligations, imputed debt and direct debt issues must be addressed in the development of the RFP process and an equity adjustment should be included in the evaluation of bids received, which warrant such treatment, along with the inclusion of transmission-related costs and operations-related costs for each bid.

5. The timeframe for the evaluation should reflect the life of a power plant to ensure that all options are compared on the same consistent basis

It is anticipated that the most likely bidders in Hawaii will be project developers proposing to construct and operate a new power generation facility to meet the power needs of the HECO Companies. As a result, all or most options will be for long-term power contracts, reflecting the life of the plant or term of financing. The life of a power plant (whether a utility plant or independent power project) is generally in excess of 30 years.

In their evaluation of IPP proposals, the HECO Companies have assumed 25 to 30 year lives for both IPP-owned and utility-owned central station generating units. As a practical matter, however, the usefulness of such facilities generally continues after the expiration of the depreciation-life period, if the facilities are well maintained.

This issue highlights a difference, however, between utility plants and IPP projects. While a utility plant may have a life exceeding 40 years, once the plant is fully

depreciated, the costs recovered from customers generally are limited to operating costs[3], including fuel, O&M, taxes, and other related costs. On the other hand, an IPP would have the opportunity to sell its power at the end of the contract term at whatever price the market could bear. The IPP, however, is not limited in its cost recovery to only operating costs.

One option to address this concern is to specify that the host utility has the right to buy the project from the bidder for $1 or some estimated salvage value at the end of the contract term. Bidders will be required to structure their bid price around the pre-specified buyout price.

A second option is to require the bidder to sell its power beyond the term of the contract, at the buyers' option, at an extension of the terms of the contract in place at the termination of the contract. This would involve extending the pricing terms out several years based on the pricing formula in place at the termination of the contract.

6. **The HECO Companies propose that a wide range of supply-side options be eligible to bid including power purchase arrangements, utility self-build options and turnkey arrangements (i.e., build and transfer option). HECO recommends that the RFP process be open to only supply-side resources, with DSM options not eligible to bid, and with Combined Heat and Power (CHP) projects worked through a competitive procurement process.**

Recent RFP processes have allowed a variety of supply-side options to compete. For example, in the Portland General Electric RFP, power purchase agreements, fully or partially completed merchant plants sales options, utility self-build, turnkey arrangements, renewable resources, short-term forward contracts, virtual tolling arrangements, and options contracts were eligible. The HECO Companies support broad eligibility for this process as well. Bidders will also be eligible to offer multiple contract structures if they so choose.

In conjunction with the inclusion of credit quality and financial impacts in the evaluation of power purchase agreements, the option for a turnkey project provides the correct signals for the bidder to structure its project recognizing the value of the project structure. For example, if bidders are concerned that a straight power purchase agreement will not be competitive if financial impacts are accounted for during the evaluation, the bidder will also have the option to offer a turnkey arrangement as well.

With regard to DSM and CHP, it is important to recognize that these resources are very different from traditional supply-side resources and should not become subject to the same evaluation process. In the past, in some cases the industry attempted to evaluate DSM and supply-side resources using the same evaluation criteria and RFP. However, these processes proved to be flawed because the resources are inherently different and

[3] Some capital costs may be incurred for refurbishment projects resulting in betterment.

require separate RFPs, evaluation criteria, and contracts. The industry standard over the past bidding cycle (e.g. since the late 1990's) has been to conduct supply-side only solicitations, rather than all-source solicitations. DSM RFPs have not been common recently.

For CHP resources, the Companies plan to use a competitive procurement process. The objectives of the competitive procurement process are, among others, (1) to ensure provision of quality CHP products and services, (2) to standardize equipment and designs, (3) to achieve efficiency in the equipment selection process, and (4) to obtain cost savings for the utility and its ratepayers, especially over the life cycle of the CHP installation. Please refer to HECO's Opening Brief in the Proceeding to Investigate Distributed Generation in Hawaii, Docket No. 03-0371, filed on March 7, 2005, Section I.D.1., pages 22 to 24.

7. The value of flexibility should be built into the competitive bidding process

Many utility competitive bidding processes recognize the value of flexibility in the evaluation of resource alternatives. Such flexibility options as contract buy-out options, project in-service date deferral or acceleration provisions, or project acquisition options are valuable options for a utility to more effectively balance its needs with the cost of obtaining such options. With the utilization of option pricing concepts in the mid-1990's in the utility industry, a number of utilities developed the procedures and models to evaluate such options in their competitive bidding processes. Bidders were required to competitively bid such options and the host utility was able to quantify such an option. HECO views such flexibility as an important criterion for the evaluation of the bids received.

Given the nature of their Island systems, the HECO Companies are also concerned about fuel flexibility and the option to convert to an alternative fuel if fuel cost or availability changes dramatically. Over a 30 year contract life, there is no way of knowing if new technologies will emerge over time that could reduce fuel costs. While non-price evaluation criteria could be included in the evaluation process, HECO prefers to include a more direct option in the RFP process to provide HECO the option to request conversion of the plant to an alternate fuel if conditions warrant, with appropriate modifications to the PPA to account for the bidder/seller's conversion costs and to pass on the benefit of the lower fuel costs.

8. The timing of implementation of any competitive bidding process needs to consider the timing of system needs

Given the time that it takes to develop and implement competitive bidding processes, it will be necessary to exempt certain near-term facilities from these processes to future units to allow for near-term needs to be met in a timely manner. (See earlier discussion.)

C. Conclusion

In conclusion, HECO has reservations about the applicability of competitive bidding to an island system such as Hawaii. HECO has a number of concerns regarding the potential shortcomings of a competitive bidding process that should be addressed in the design, development and implementation of a competitive bidding program. Without resolution of these issues HECO could not support the institution of competitive bidding for acquiring or building new resources in Hawaii.

Issue 2a: How can a fair competitive bidding system be developed that ensures that competitive benefits result from the system and ratepayers are not placed at undue risk?

HECO/HELCO/MECO Position:

Competitive bidding processes are very complex and require an assessment of a number of factors to ensure a balance between encouraging competitive benefits and providing customers with the best resource options while ensuring reliability. Developing a fair and competitive bidding system requires an identification of the characteristics of successful competitive bidding processes that have effectively addressed fairness and bias issues. To address these considerations, it is important to assess the characteristics of successful bidding processes to establish the parameters for developing such a system and to also consider some of the recent lessons learned in other competitive bidding processes to provide some guidance in the development of such a process.

A. Characteristics of Successful Competitive Bidding Processes

There are a number of characteristics of a successful competitive bidding process that can serve as a basis for developing such a process if the Commission decides to pursue competitive bidding.

1. **The competitive bidding process should be fair and equitable to all bidders.**

   The competitive bidding process should allow for the flexibility to make adjustments as necessary to ensure these criteria are met. All bidders should be treated the same in terms of access to information, time of receipt of information, and response to questions. One mechanism for ensuring bidders have access to information is for the utility to develop a website where it can post documents and information for bidders to access. Bidders should have a general knowledge of the bid evaluation and selection process. This generally involves an identification of the criteria of importance to the utility in the RFP document. The bidder can then reflect these criteria in its bid.

2. **The solicitation process should ensure that competitive benefits for utility customers and stakeholders result from the process.**

   A well-designed competitive bidding process should provide competitive benefits for both utility customers and shareholders. Customers can benefit through lower costs for power driven by competition. Shareholders benefit through lower regulatory risk involving the utility's ability to recover all reasonable costs. An effective competitive bidding process should serve both purposes. An effective competitive bidding process should encourage lower prices with an appropriate balance of risk and account for all reasonable costs in the evaluation process.

   As noted in response to Issue 2, all reasonable costs should be validated in the evaluation process for either all the bids received or a short-list of bids based on the number of bids

received. The balance between cost and risk can also be addressed by including a model power purchase agreement in the RFP document. This allows bidders the opportunity to review and assess the contract provisions of importance to the host utility and reflect these terms in its price. The contract terms proposed by the HECO Companies will need to reflect the value of reliability of power supply on a system such as an Island utility system.

3. **The competitive bidding process should be designed to encourage broad participation from potential bidders.**

To ensure that all reasonable options are effectively considered, there should be no unreasonable restrictions on sizes and types of projects. It is generally preferable that all types of eligible projects (e.g. supply-side options) have a fair opportunity to compete. This will ensure that all eligible resource options are considered in the selection process, and a lowest cost resource plan can ultimately be developed. It is not always reasonable to establish a target number of bids as a basis for success because the size and diversity of the market may influence the amount of bidders and capacity bid.

Another issue is the type and form of threshold criteria to apply for the competitive bidding process. Stringent threshold criteria (i.e. bidder has to have site control, maintain a certain credit rating, demonstrate the technology used is mature, have identified all environmental permits, etc.) are generally applied when the market is not very mature and the risk of project failure is great. Lenient threshold criteria are generally applied in a mature market or a case where market access to other resources is easy in case of project failure. HECO expects that more stringent threshold criteria will be necessary for the island systems since the risk of project failure can be significant for utility customers. Thus, it is important that bids received have been in the development process for a reasonable amount of time.

4. **The Request for Proposal document (i.e. the RFP, Response Package, and Power Contracts) should describe the bidding guidelines, the bidding requirements to guide bidders in preparing and submitting their proposals, the bid evaluation and selection criteria, and the risk factors important to the utility.**

The above referenced information identifies the important requirements of the utility and places bidders on an equivalent basis. This objective can be met through a well-designed RFP that provides details on the process and defines bidder requirements. It is not necessary for this solicitation process to be a transparent, self-scoring system to meet this objective. Transparent processes, while more bidder-friendly, create gaming opportunities and lead to more complaints and a more contentious process. Self-scoring systems are not the norm. Solicitation processes that provide adequate information on the requirements of the purchasing utility, provide clear and concise information to bidders on the requirements for completing their proposal, and identify in sufficient detail the evaluation and selection criteria are consistent with this overall objective.

One of the major challenges in the design and development of the RFP process is to ensure the RFP document, response package (information requested of bidders to allow the utility to evaluate the bids relative to the criteria established) and power purchase agreement are closely aligned and integrated. It is common that a change in one document leads to changes in other documents as well and such tracking is necessary to avoid inconsistent signals to bidders.

5. **The solicitation process should include thorough, consistent and accurate information on which to evaluate bids, a consistent and equitable evaluation process, documentation of decisions, and guidelines for undertaking the solicitation process.**

   In this regard, it is important that bids are evaluated based on a consistent and thorough set of information provided by the bidder, the utility, and outside independent sources. The RFP should require bidders to provide information consistent with the evaluation criteria to ensure that the important attributes of each proposal can be equitably and fairly evaluated. For example, in order to assess whether the capacity proposed by bidders can in fact be built, each bidder's proposal needs to contain information regarding the bidder's control of the site upon which the capacity will be built, and the technology to be installed, as well as information upon which an assessment of the permittability of the unit can be made. The forecasts and other information provided by the utility should include outside sources as well as system specific information. The solicitation and evaluation process should also ensure that the results of the evaluation process can be fully documented.

6. **The solicitation process should ensure that the power purchase agreement is designed to minimize risk to utility customers and shareholders while providing a reasonable opportunity to finance the project.**

   It is not in the best interest of the host utility if the evaluation process selects a project but that project cannot secure financing because of onerous terms in the contract. At the same time, contracts that could lead to significant risk to the utility and its customers are also not in the best interests of these parties and could lead to serious financial implications. As a result, it is important that the contract provides a proper balance of risks between buyer and seller, with each party incurring the risks it is most capable of managing. In the HECO Companies' case, the contract provisions have to reflect the nature of an island utility system.

   In most cases, the utility will include a copy of the model power contract in the RFP (or multiple copies if different types of resources are expected to bid). While utilities will identify certain terms and provisions that may not be negotiable, usually the bidder has the opportunity to raise exceptions to the contract and the utility can gauge whether or not such exceptions are reasonable or could lead to a fatal flaw in negotiations. In most cases, the utility does not have to accept the exceptions taken by the bidder.

7. **The solicitation process should incorporate the unique aspects of the utility system and the preferences and requirements of the utility and its customers.**

   Each utility system is unique in terms of its existing resource mix, customer profile, transmission and locational issues, regulatory requirements, operational considerations and customer preferences. These unique aspects of the utility system must therefore be addressed in the design of the solicitation process. As a result, the evaluation criteria should reflect the factors of importance to the utility customers and shareholders. Reflecting utility specific preferences in the design of the solicitation process is an important aspect of an effective solicitation process.

   This is particularly important for an island system, where attributes such as quick load pick-up for proposed units, spinning reserves, redundancy criteria, ramp rates and load following capability, dispatchability, and other operational flexibility attributes are important, and should be required of bidders.

B. Lessons Learned in Recent Competitive Bidding Processes

Competitive bidding processes are evolving with the changes in the power market. The following points describe some of the recent trends and initiatives with regard to competitive bidding processes and the implications of these initiatives for guidance in the design and development of an effective competitive bidding process.

1. It is important to establish the "rules of the game" before undertaking a competitive bidding process. Bidders prefer to know before undertaking the development of a proposal "how the winner will be selected". Establishing the ground rules up-front to allow bidders and other stakeholders the opportunity to consider all factors before deciding to participate is important to ensure a successful process. Poorer, more contentious competitive bidding processes result from the development and implementation of a competitive bidding process without the consideration and resolution of a number of key issues that could influence the process.

2. Due to the financial crisis in the electric generation industry, credit quality of the counterparty is now one of the most important evaluation criteria in competitive bidding processes.

3. Integrated evaluation systems using sophisticated production cost and generation planning models for bid evaluation are the norm in the industry. These models allow the utility to capture the cost and operational impacts on its system based on the individual proposal or portfolio of proposals.

4. Price-related evaluation criteria are the predominant selection criteria. Non-price criteria are used to ensure the project or portfolio is viable and feasible but price is usually the ultimate determinant.

5. Recent credit problems of some independent generators have generally led to higher equity ratios and higher debt costs for IPPs.

6. Recent bidding rules and guidelines recognize the value of allowing all options to compete, including utility projects and turnkey arrangements.

7. Utility projects are more economic relative to IPPs and have been successful in several solicitations.

8. Supply-side and DSM RFPs are generally undertaken as separate processes, not as an all-source process due to the unique nature of the resources.

9. The failure rate of projects is a significant factor. It is important to realize that not all projects awarded a contract will succeed and not all projects that win a bid will end up successfully negotiating a contract. This issue has become more prominent since the financial condition of the counterparty can lead to decisions by IPPs to terminate a project, even one with the possibility for a long-term power contract. Power generators in poor financial health may be required by their lenders to direct available capital to other projects.

10. Power contracting has become much more complex and time consuming due to the more stringent contract terms required of utilities as a result of the increased risk associated with financially challenged power generators and the desire of the power generators to avoid absorbing this risk.

11. In more RFP processes, all system costs are being included in the analysis, including transmission costs and system operations costs.

12. The time, cost, and resource commitment necessary to carry out a competitive bidding process can be significant, with a timeframe from initiation of RFP design to contract negotiation lasting up to two years. This lengthy time requirement can also discourage bidders from holding their price open for this long of a period.

13. Some utilities are taking on the fuel supply function for IPPs through tolling arrangements.

14. Transmission costs (i.e. interconnection costs, system upgrades required to facilitate delivery of power, and direct transmission costs) are having an impact on distinguishing projects.

15. The impacts of direct and imputed debt as a component of the bid evaluation process are being recognized by a number of regulatory commissions and utilities as an important factor in evaluating and selecting resource options.

Issue 2b: What are the specific competitive bidding guidelines and requirements for prospective bidders, including the evaluation system to be used and the process for evaluation and selection?

HECO/HELCO/MECO Position:

The guiding principles which underlie the HECO Companies' initial position on a potential competitive bidding process include the following:

1. The bidding rules and guidelines must address the unique nature of the electric utility system in Hawaii relative to mainland systems.

2. The bidding rules and guidelines should recognize the significant role already played by independent power generators in the Hawaii electric market.

3. As previously noted, the development of competitive bidding rules and guidelines should be developed from the ground up without superimposing another state's system directly in Hawaii.

4. The development of competitive bidding rules and guidelines should identify and address potential shortcomings associated with the development of such a system, including the timing requirements necessary for developing the appropriate structure, the process for integrating the RFP with the IRP process, the role of the utility as a major stakeholder in the process, consistent treatment for all options, which reflects the true cost of the power to the utility's customers, and a reflection of the operational considerations and costs associated with each resource option.

Should the bidding rules be developed and put in place, the HECO Companies recommend that the first RFP process be undertaken in conjunction with the next IRP process. As noted in the response to Issue 2, the HECO Companies recommend that the IRP be used to identify the timing and amount of resource requirements along with the preferred resource or resources. The RFP will then be used to fill that need based on actual market options.

Once this process is initiated, the HECO Companies propose a multiple stage process to implement the competitive bidding process. The stages of such a multi-stage process, and the major tasks and issues that generally would be included in each stage, are described below:

Stage 1: Develop the RFP

There are several components of this task. These include addressing the key policy issues associated with the RFP design and development. Some of these issues may be addressed in the establishment of rules and guidelines underlying the competitive bidding process. Some of the key issues that must be addressed at this stage include:

- Resolve any issues associated with the role of bidding in the IRP process. As previously noted, HECO advocates integrating the IRP and RFP process, with the IRP used to define the amount of capacity to solicit and the timing of need.

- Determine the type of bidding process to implement. HECO supports a multi-stage evaluation system that includes threshold, price and non-price evaluation criteria. HECO, however, proposes to use a price-driven process as the basis for selection of the preferred resources. (Under such approach, the utility subjects all proposals to the threshold criteria, then organizes or clusters bids that pass the threshold criteria by type of resource (i.e. wind bids, combined cycles and combustion turbines will be evaluated together) and subjects all proposals to a price screen and non-price analysis. Price and non-price points are determined for each proposal within the cluster. The best projects within each cluster (from a price and non-price perspective) are included on the short list. Generally, all proposals on the short list are considered viable and feasible projects. The final evaluation is based on determining the option or portfolio of options which result in the lowest net present value revenue requirements for the overall resource plan.)

- Determine bidder eligibility. As previously noted, the HECO Companies generally support an all supply source RFP (including conventional supply-side resources and renewable technologies) with eligibility including independent power projects, utility self-build option, and turnkey arrangements. HECO does not support all source bidding given the complexities of including DSM in the bid evaluation and selection process.

- Establish the price evaluation methodology. HECO proposes to undertake a detailed system evaluation process using the same models and methodologies used for the IRP process. The RFP will contain the data required of bidders in their proposals for undertaking the analysis. The bids would be evaluated over a time horizon that takes into account the expected lives of generating facilities.

- Identify the price and non-price criteria and the weights associated with each general criterion. For the non-price factors, such characteristics as development feasibility (site status, environmental permitting, financial plan, critical path, etc), operational viability (O&M plan, fuel supply plan, etc.), operational requirements (i.e. dispatchability, ramp rates, spinning reserves, load following capability, etc.), and flexibility (i.e. contract buyout options, fuel conversion option) should be included.

- Establish the role of the utility in the RFP process and any safeguards required. As noted, consistent with the majority of RFP processes, HECO supports an active role for the host utility in every phase of the RFP process. This includes development of the RFP, evaluation of bids and selection of the short-list, and development and preparation of the utility's self-build option. Procedures would

be developed prior to initiation of the bidding process to define the roles of the members of the various project teams, outline the communication process with bidders, and to address confidentiality of the information provided by bidders.

- Establish credit requirements and security provisions. These components have become more important based on the financial condition of a number of power generators and the risk and cost of project failure. In RFPs dealing with isolated systems or island systems, the security requirements included have been fairly stringent. For example, the recent BC Hydro Call for Tenders for power on Vancouver Island contained fairly stringent security requirements to ensure well financed bidders would compete and to discourage bidders from defaulting on the contract or terminating their project.

- Develop the model Power Purchase Agreement. As previously noted, contract issues are becoming more complex and new provisions are being included in the contract. Provisions addressing liquidated damages, flexibility options (buyout or delay provisions, fuel conversion provisions, etc.), asset transfer arrangements, and other matters have to be included. Existing PPAs would be used as the starting point, but additional provisions generally included in more recent contracts resulting from competitive bid processes could also be included.

- Assess the appropriate methodology for evaluating the impacts of purchased power in the bid evaluation process. This is a very important factor for utilities with significant purchased power obligations such as HECO.

- Establish the operational parameters required (or preferred) of units bid into the RFP, including dispatchability, minimum turndown, ramp rates, and other performance criteria as may be applicable to the specific technology. Ideally, these requirements should be consistent with the utility's own requirements.

- Develop the methodology necessary for conducting the transmission cost assessment. Decide if the utility will conduct interconnection studies on behalf of or for bidders.

Other issues which must be considered in Stage 1 include the following:

- Development of an internal implementation schedule with the tasks and manpower requirements for undertaking the RFP process;

- Development of the evaluation criteria and weights, generally through an iterative process;

- Development of a procedures manual which describes the documentation process, reporting requirements, organizational structure, communications requirements, etc.;

- Development of the model Power Purchase Arrangements;
- Prepare draft of the RFP and response package;
- Develop database for documenting the bid evaluation and scoring process;
- Develop a website for communication with bidders;
- "Stress Test" the evaluation system using hypothetical bids; and
- Incorporate revisions to the RFP.

In total, this Phase of the process could take approximately 6 months from initiation of the RFP development phase, or substantially longer if prior approval of the RFP is required.

Stage 2 Issue the RFP/Bid Preparation

Stage 2 activities involve the period from issuance of the RFP to receipt of bids. An important aspect of Stage 2 is the marketing of the RFP. It is typical for utilities to announce the issuance of the RFP through the trade press as well as notifying potential bidders that have expressed an interest in bidding. Utilities now generally post the RFP on the Company's established RFP website with information guiding the potential bidder. This process ensures that potential bidders have access to the RFP and any related materials.

It is also common in this stage for the host utility to conduct a Bidders Conference. The Bidders Conference generally allows bidders the opportunity to attend a presentation by the utility conducting the RFP and ask questions about the RFP and the bidding process. Again, this provides bidders the opportunity to seek and receive information about the process in preparation for their bid.

Most RFP processes request that bidders complete and submit a Notice of Intent to Bid form to the host utility. This provides an indicator to the host utility about the number of potential bidders. Once the Notice of Intent is filed, bidders are either provided a password to access information about the RFP process, including responses to questions, any addendum, and other information or have unfettered access via the host utility's website.

The last major activity at this stage of the process is the response by the host utility to bidders' questions. The responses to questions provided on the host utility's website are generally considered the official response of the utility and ensures that a consistent response is provided. This eliminates the possibility that someone within the Company may provide an unofficial answer which can influence the decisions of the bidder. The

official response can reflect the input of a number of staff and management personnel with the host utility to ensure the official answer is provided.

The bid preparation process generally takes 3-4 months even if potential bidders are aware of the process in advance. Bidders generally start committing serious money to the bid preparation process after they have reviewed and studied the RFP.

Stage 3: Evaluation of Bids

Stage 3 is a major step in the process. For the bid evaluation, most utilities utilize a multi-stage process designed to eventually reduce the bids down to a selected few or what is commonly called the award group. A proposed evaluation process will be described below in some detail. The multi-stage evaluation process generally includes: (1) receipt of the proposals; (2) completeness check; (3) threshold or minimum requirements evaluation; (4) initial evaluation including price screen/non-price assessment; (5) selection of the short list; (6) detailed evaluation or portfolio development; (7) select award group for contract negotiation; and (8) management (and sometimes board) approval of the contract(s).

The first step in this stage of the process is the receipt of proposals. Generally when bids are received they are date stamped and organized and in most cases coded by number or letter. The proposals are generally maintained in a secure area to limit access to the bids to only those authorized members of the project team. This process ensures that competitive information is not distributed to any unauthorized individual. Bids are either disseminated to members of the project team or team members have to review the bids in a central secure location.

The initial review of the proposals includes a completeness check to ensure all the relevant information is provided with each bid and all bids can then be evaluated using an organized, structured process.

Bids that do not provide all the information requested could be rejected and the proposal returned to the bidder. In some RFP processes, the host utility may submit clarification questions to bidders if the information presented in not complete or clear. These questions are generally issued only when the request for clarification or information does not jeopardize the competitive nature of the process.

Bids that are deemed complete are then subject to the threshold criteria stage of the process. The threshold or minimum requirements evaluation is designed to ensure that bidders have met some minimum standards with regards to the development of their projects. Bids which fail to meet the established minimum requirements will be subject to rejection. The threshold or minimum requirements will be identified in the RFP so that bidders will clearly know the standards that must be met for qualifying for the evaluation of the bids.

Bids that meet the threshold or minimum requirements are then generally subject to an initial evaluation. At this stage it is common for utilities to segregate bids into different technologies or categories and conduct a price screening analysis of all bids as well as a non-price evaluation. The methodology used for the price screen phase could be real levelized cost analysis or an internal model designed to conduct an initial assessment of bids.

On the mainland, a separate project team may conduct a detailed non-price evaluation of the bids relative to the non-price evaluation criteria selected. There are a number of possible approaches for ranking bids at this stage. First, a common approach is to combine price and non-price points based on a pre-established weighting system and rank the bids based on points. The highest ranked bids in each category would then be subject to the detailed price or portfolio evaluation. The intent is to select bids that are both low cost and are viable projects (bids which have a high likelihood of success). A second option used is to conduct a pass/fail assessment of each bid relative to the non-price criteria. Bids that "pass" at this stage are included in the final evaluation.

The result of this stage of the bid evaluation process is a selection of a short-list of bids that will be considered in the final evaluation. On the mainland, the short-list often includes two to three times the amount of capacity required in the RFP to ensure several portfolios can be developed and evaluated. In many cases, system costs associated with transmission impacts, inferred debt impacts, and system operational factors can be taken into consideration.

Based on the detailed or portfolio analysis, the preferred resources can be selected based on their total system cost impact. It is common practice for a host utility to select a winning bid as well as a back-up in case the preferred bid fails or is not able to negotiate a contract.

The final step in the process is generally a board or senior management presentation detailing the basis for selection of the winning bid followed by Board or senior management approval.

This process can take at least 4 months and depends on the number of bids received.

Stage 4: Contract Negotiations

As previously noted, the contract negotiation process is becoming more complex and time consuming due to the poorer credit quality of a number of power generators, the requirements of the banks involved in project financing, and the requirements of the purchasing utility. There have been several recent examples of bidders agreeing to the major contract provisions outlined in the utility's model power purchase agreement and then reneging on these requirements during the contract negotiation process. For example, Hydro-Quebec Distribution Company's first Call for Tenders included specific security requirements in both the Call for Tenders document and the model power

purchase agreement. The winning bidder agreed to these requirements when it submitted its proposal. However, two months into the contract negotiation process, the bidder decided it could not accept the security provisions. Hydro-Quebec then terminated negotiations and had to initiate contract negotiations with the back-up bidder, effectively delaying the process by more than two months. This is not uncommon in the industry today in cases where the bidder is under no penalty if it decides to terminate negotiations or cancel the project. In a recent Call for Tenders involving BC Hydro, the utility included strict provisions in the contract that severely penalized a bidder from terminating a project if it was selected as the winning bidder.

Nevertheless, there are several steps involved in the contract negotiation process. In many RFPs, bidders are provided a model power purchase agreement and have the opportunity to list exceptions to the contract. The utility has the option of agreeing to these exceptions. However, the exceptions at least provide the utility with a base of knowledge to begin contract negotiations.

The utility also has to organize the contract negotiation team. The team generally consists of a lead attorney, a credit specialist, a commercial specialist, and possibly a system operations specialist. Negotiation of credit terms has become a very important aspect of the contract negotiation process over the past few years.

It is not uncommon for the contract negotiation process to take from 3-12 months. Contract negotiations in the recent Portland General RFP process took nearly 12 months to complete. To avoid such protracted delay, some utilities will establish a time limit for contract negotiations (i.e. 2 to 3 months) and specify the limit in the RFP document. The utility has the right to terminate negotiations and move on to the next bidder if a contract is not completed or substantially completed within that timeframe. This ensures the utility does not face reliability problems if a bidder negotiates for several months, terminates the project, and the utility has no other alternatives. This is particularly problematic in a utility system such as Hawaii.

During contract negotiations, senior management will be informed of the status of the negotiations process. Negotiations are not complete until the management (and sometimes the board] of the utility (and likely the developer as well) have agreed to all terms and conditions prior to submission of the contract for regulatory approval.

Stage 5: Regulatory Approvals

In many states, the Commission has to either approve the resulting power contract or grant a certificate of need if a self-build option or turnkey arrangement is awarded the contract. This can also be a time consuming process depending on the other commitments of the Commission and the presence of any major intervenors.

Issue 2c: How can a fair competitive bidding system encourage broad participation from a range of prospective bidders?

The HECO Companies caution that the response to a competitive bidding process in Hawaii will likely not achieve the same level of activity as on the mainland. This is due to the smaller capacity requirements in Hawaii, the lack of merchant plants seeking power contracts, lack of short-term options, and more limited market access. In addition, development costs are likely to be higher and economies of scale are not significant.

While there is no guarantee that a competitive bidding process in Hawaii will generate a broad range of bids from a number of suppliers, the design of a fair and equitable bidding process will likely generate more interest from bidders. In deciding whether or not to bid and the type of product to propose, a bidder has to assess its chance of winning relative to the cost of developing and submitting a bid. If a bidder expects the process to be a fair and competitive process and if he understands the ground rules, the bidder can make a more informed decision.

Some of the ways for the host utility to encourage broad participation from a range of prospective bidders include:

- Clearly inform bidders of the requirements for bidding. The RFP should provide substantial details on the bidding process and the requirements for submitting a proposal. Therefore, bidders will know the rules of the game before developing a proposal.

- Provide guidance to bidders regarding the basis for "winning the bid". Bidders all want to know how they can win the bid. This involves providing a description of the bid evaluation and selection process in the RFP.

- The development of bidding guidelines and rules up-front provide guidance to bidders and ensure the process is not likely to continually change or evolve through the bidding process. One problem in some RFP processes that discourage bidders is a change or multiple changes in schedule. Bidders prefer a degree of certainty in the process. The Hydro-Quebec Call for Tenders process has been viewed favorably by the bidders because the process has been consistent and on schedule. Bidders know the rules of the game and that Hydro-Quebec will follow the rules as defined.

- Include reasonably transparent evaluation criteria that inform bidders of the criteria of importance to the utility. In most RFPs, utilities will identify the general evaluation criteria with an indication of the weights for each criterion. The utility will then develop an evaluation methodology designed to allocate points or scores for each criterion that are used by the utility's bid evaluation team in the bid evaluation process.

- Including a model power purchase agreement in the RFP document provides valuable information to bidders deciding whether or not to bid and what level of risk is required. Bidders can then reflect that risk in their proposal.

- In some RFP processes, an Independent Observer or Independent Reviewer is retained by the utility (in some cases with the approval of the Commission) to observe and/or audit the bid evaluation and selection process. The utility conducts the evaluation of the bids and is responsible for selecting the winners and negotiating contracts. If an Independent Observer is requested, HECO recommends that the role of the Independent Observer be to manage correspondence between the utility and bidders, review and audit the results of the evaluation process, and advise the utility if there are any fairness issues.

  In order to be effective, Independent Observers should have a demonstrated track record of impartiality, be able to work effectively with the utility over the long term, be able to report candidly to the Commission, and be knowledgeable about the unique characteristics and needs of the small, non-interconnected island electric grids

  If an Independent Observer is required, the Independent Observer selected should meet certain criteria, including:

    - Be familiar with island utility systems and be aware of the unique challenges and operational requirements of such systems.

    - Have the necessary experience and familiarity with utility modeling capability, transmission system planning, operational characteristics, and other factors that affect project selection.

    - Have the capability of working with the utility during the evaluation process.

  HECO could identify potential candidate consulting firms to serve as the Independent Observer and accept candidates provided by the Commission as well. HECO could ask the Commission to review the list and approve the list of candidates. HECO could then issue and RFP for consulting services from candidates on the list and select the consultant that meets the criteria established.

- Establish a website for communicating with prospective bidders that ensures all bidders receive information about the process at the same time.

There are a number of examples of recent RFPs that highlight these points. For example, the Portland General Electric RFP was developed within the bidding guidelines in Oregon. Portland General conducted several workshops for potential bidders and provided draft copies of the RFP. The RFP clearly identified the requirements of bidders, including providing a bid form or response package that identified the information requested of bidders as well as the criteria of importance and their general weights. The eligibility requirements of the RFP were very broad including conventional supply-side options, potential ownership options from existing or partially completed merchant generation facilities, renewable resources, and an identified self-build option. Portland General included general information about its self-build option in the RFP including the technology selected, estimated overnight capital costs, heat rate information,

etc. Portland General also included several model power purchase agreements based on the different products requested. Portland General received over 100 proposals for a broad range of products from a variety of bidders.

Portland General also retained an independent third-party observer to validate that the scoring criteria did no inappropriately bias the process in favor of equity investment by Portland General.

Issue 3: What revisions should be made to the integrated resource planning process?

As described in the response to Issue 2, should competitive bidding be implemented in Hawaii, HECO proposes that the IRP and RFP processes become integrated. HECO proposes a process whereby the IRP is initiated first before the RFP is issued. The IRP identifies the preferred resource plan. The IRP also determines the amount and timing of resources required, the preferred capacity type, any preference or criteria for resource selection, and determines the avoided cost. The preferred plan or target portfolio is identified.

In parallel with this process, the utility develops the RFP. The RFP is issued after the preferred plan or target portfolio is identified. The utility then collects and evaluates bids from suppliers. The bids are compared to the cost of the generic resource or project selected in the IRP. The preferred bid is selected from the bids received and evaluated and the utility negotiates a contract with the selected bidder.

For this option, the role of the advisory groups will still be applicable for the IRP process and is not expected to change from previous IRPs. However, while the advisory groups may have input into the development of the RFP if a collaborative process is followed, the advisory groups will have no input beyond that stage. Information provided by bidders in their proposals and in contract negotiations is confidential and competitively sensitive. Any suggestion to disclose any of this information could violate the objective of encouraging broad participation in the bidding process. HECO could envision providing status reports to the Commission staff during the competitive bidding process, based on agreed upon confidentiality guidelines.

Finally, should competitive bidding be implemented in Hawaii, revisions to the Framework for Integrated Resource Planning may be appropriate to account for the integration of the RFP process with the IRP process. It would be premature to propose specific changes to the Framework before competitive bidding guidelines, if any, are adopted.