EXHIBIT C

COMPETITIVE BIDDING FOR NEW GENERATING CAPACITY– ACCOUNTING ISSUES

CONSOLIDATION ACCOUNTING ISSUE

Background

Consolidation accounting refers to the financial statement reporting treatment whereby the financial statements (i.e. income statement, balance sheet, and statement of cash flows) of one entity are put together with the financial statements of another entity and reported as if it were a single entity. Prior to 2003, the primary source of accounting guidance on the subject of when entities should be consolidated for financial reporting purposes was Accounting Research Bulletin No. 51, "Consolidated Financial Statements" ("ARB 51"). ARB 51 had required that an enterprise's consolidated financial statements include subsidiaries in which the enterprise had a controlling financial interest. The requirement usually had been applied to subsidiaries in which the enterprise had a majority voting interest.

In January 2003, the Financial Accounting Standards Board ("FASB")[1] issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). FIN 46 was an interpretation of ARB 51. FIN 46 changed the criteria used to determine whether and how certain relationships should be reported on consolidated financial statements. The primary objective of FIN 46 was to provide guidance on the identification of, and financial reporting for, entities over which control was achieved through means other than voting rights.

Under FIN 46, such entities meeting certain specific criteria are deemed "variable interest entities" ("VIE"). VIE identification requires an economic analysis of the rights and obligations of an entity's assets, liabilities, equity, and contracts or arrangements with other parties. Variable interests are interests in an entity that change with the fair value of the net assets[2] exclusive of the variable interest. If an entity is determined to be a VIE, a determination must be made as to whether there is a "primary beneficiary". The "primary beneficiary" is the enterprise that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. The primary

[1] Since 1973, FASB has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979).

[2] FIN 46R uses the terms "expected losses" and "expected residual returns" to describe the expected variability in the fair value of the entity's net assets exclusive of variable interests. Expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions. Expected variability is the sum of the absolute values of the expected residual returns and the expected loss.

beneficiary must consolidate the VIE. FIN 46 required extensive judgment and estimates, but provided very little assistance in making them. Companies struggled with how to implement FIN 46. FIN 46 was effective immediately for entities created on or after February 1, 2003, however, its implementation was later deferred.

In December 2003, FASB issued a revised FIN 46 ("FIN 46R"). FIN 46R was effective for financial statements for periods ending after March 15, 2004. The summary section of FIN 46R is attached. Although FIN 46R provided some clarification, there are many issues in FIN 46R that are subject to interpretation. In early 2004, HECO became aware that certain interpretations of FIN 46R resulted in independent power producers ("IPPs") being deemed VIEs. Further, an interpretation that a purchaser absorbing fuel oil price risk (regardless of any current ability to recover the changes in price from customers) was the "primary beneficiary" of the VIE and required the purchaser to consolidate the VIE.

In early 2004, there was considerable uncertainty as to the application of FIN 46R. HECO participated in industry discussions on the applicability of FIN 46R to PPAs. In March 2004, the Edison Electric Institute ("EEI") wrote to the FASB providing EEI's assessment of the applicability of FIN 46R in specific PPA scenarios and requesting a delay in the implementation of FIN 46R.[3] FASB did not respond to EEI's request for a delay in implementation. In March 2004, HECO determined that all the purchase power agreements were potential VIEs and that it might be possible that HECO may be deemed the primary beneficiary. In compliance with FIN 46R, HECO requested information from the independent purchase power producers with which it had purchase power agreements ("PPA") with in order to determine the proper accounting treatment of the specific PPA. A request to Kalaeloa was sent on or about March 9, 2004 in connection with its existing agreement with HECO. Kalaeloa has declined to provide the information requested.

FIN 46R specifically identifies several situations in which FIN 46R does not apply (see "Exceptions to the scope this Interpretation" on the FIN 46R summary attached). To date, all the existing PPAs have been deemed exceptions to the scope of FIN 46R. For VIEs created before December 31, 2003, the purchaser (in this case, HECO) is not required to apply FIN 46R if after making an "exhaustive effort", HECO is unable to obtain the information necessary to determine whether the entity is a VIE, and if it is a VIE, whether HECO is or is not the primary beneficiary. Since the existing Kalaeloa contract was in existence at December 31, 2003 and since Kalaeloa did not provide HECO with information to make its own assessment as to whether Kalaeloa is a VIE and which party, if any, is the primary beneficiary, the existing Kalaeloa contract was deemed to fall within a scope exception to the application of FIN 46R.

Although FASB did not directly respond to the EEI letter raising issues with respect to the applicability of FIN 46R to purchase power agreements, the Emerging Issues Task Force ("EITF" or "Task Force")[4], addressed certain issues with respect to the

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[3] See attached letter dated March 16, 2004 from EEI to FASB.
[4] The mission of the EITF is to assist the FASB in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing

implementation of FIN 46 in EITF Issue No. 04-7 "Determining Whether an Interest Is a Variable Interest in a Variable Interest Entity" ("ETIF 04-7"). EITF 04-7 raised two issues: 1) what aspects or components of the variability of an entity's net assets (exclusive of variable interests) should be considered when determining whether an interest is a variable interest and 2) when determining whether an interest is a variable interest, whether long positions of a VIE that are synthetically created by derivative transactions should be considered in the same manner as long positions created by cash transactions. In June 2004, EITF discussed issue 1 and asked the FASB staff and a working group to further develop material to be discussed at a future meeting. The EITF did not discuss issue 2. Further discussion is expected at a future meeting.

Need for requiring information to comply with FIN 46R

Based on consultation with our independent certified public accountants ("CPA"), KPMG LLP, and outside counsel, Goodsill, Anderson, Quinn, and Stifel, HECO has determined that any new or amended contracts with IPPs will include provisions to require that the IPP provide information in order for HECO to comply with FIN 46R. The requirement to provide information is necessary since there are no scope exceptions for entities created after December 31, 2003 (i.e. any new contracts). Further, interpretations of FIN 46R have resulted in guidance that any amended contract would preclude the continued use of the scope exception for entities in existence prior to December 31, 2003.

The inability to comply with FIN 46R may preclude the Company from obtaining an opinion from our independent CPA that the Company's financial statements are prepared in accordance with generally accepted accounting principles. HECO's parent companies (HECO and HEI) have publicly-traded securities registered with the Securities and Exchange Commission ("SEC") and must provide financial statements certified by a CPA in its registration statements filed with the SEC. Further, if it is determined that Kalaeloa is a VIE and that HECO is the primary beneficiary, HECO would have to consolidate Kalaeloa in its financial statements. If consolidation is required, HECO management must also assess Kalaeloa's internal controls over financial reporting in order to comply with section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404"). The inability to provide certified financial statements may result in SEC[5] action against the Company.

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authoritative literature. The EITF was designed to promulgate implementation guidance within the framework of existing authoritative literature to reduce diversity in practice on a timely basis. Task Force members are drawn from a cross-section of the FASB's constituencies, including auditors, preparers, and users of financial statements. If the EITF can reach a consensus on an issue, usually that is taken by the FASB as an indication that no Board action is needed. The Task Force meets periodically throughout the year. If the Task Force is unable to reach a consensus, it may be an indication that action by the FASB is necessary. A consensus on an EITF issue is reached if no more than three of the voting members present at the meeting object to a proposed position on an issue. Although FASB Board members do not vote on consensuses at Task Force meetings, all consensuses are subject to ratification by the FASB at an ensuing open public meeting of the Board.

[5] The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

Information necessary to address the applicability of FIN 46R

FIN 46R uses the term "entity" to refer to any legal structure used to conduct activities or to hold assets. FIN 46R applies to all entities except the following: (paragraph 4)

a. Not-for-profit organizations are not subject to this Interpretation unless they are used by business enterprises in an attempt to circumvent the provisions of this Interpretation.

b. Employee benefit plans subject to specific accounting requirements in existing FASB Statements are not subject to this Interpretation.

c. Registered investment companies are not required to consolidate a variable interest entity unless the variable interest entity is a registered investment company.

d. Transferors to qualifying special-purpose entities and "grandfathered" qualifying special-purpose entities subject to the reporting requirements of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* do not consolidate those entities.

e. No other enterprise consolidates a qualifying special-purpose entity or a "grandfathered" qualifying special-purpose entity unless the enterprise has the unilateral ability to cause the entity to liquidate or to change the entity in such a way that it no longer meets the requirements to be a qualifying special-purpose entity or "grandfathered" qualifying special-purpose entity.

f. Separate accounts of life insurance enterprises as described in the AICPA Auditing and Accounting Guide, *Life and Health Insurance Entities,* are not subject to this Interpretation.

g. An enterprise with an interest in a variable interest entity or potential variable interest entity created before December 31, 2003, is not required to apply this Interpretation to that entity if the enterprise, after making an exhaustive effort, is unable to obtain the information necessary to (1) determine whether the entity is a variable interest entity, (2) determine whether the enterprise is the variable interest entity's primary beneficiary, or (3) perform the accounting required to consolidate the variable interest entity for which it is determined to be the primary beneficiary. The scope exception in this provision applies only as long as the reporting enterprise continues to be unable to obtain the necessary information.

h. An entity that is deemed to be a business (as defined in this Interpretation) need not be evaluated to determine if it is a variable interest entity unless one of the following conditions exists:

    1) The reporting enterprise, its related parties, or both participated significantly in the design or redesign of the entity, and the entity is neither a joint venture nor a franchisee.

2) The entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting enterprise and its related parties.

3) The reporting enterprise and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the entity based on an analysis of the fair values of the interests in the entity.

4) The activities of the entity are primarily related to securitizations, other forms of asset-backed financings, or single-lessee leasing arrangements.

i. An enterprise is not required to consolidate a governmental organization and is not required to consolidate a financing entity established by a governmental organization unless the financing entity (a) is not a governmental organization and (b) is used by the business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation.

HECO requires any information that would result in Kalaeloa qualifying under any of these scope exceptions. HECO needs additional information to determine whether or not Kalaeloa is a "business" as defined by FIN 46R, Appendix C[6] and might qualify for the business scope exception under paragraph 4(h). HECO did not participate in the design of Kalaeloa therefore paragraph 4(h)(1) does not apply. However, if it is a business, HECO needs information to determine whether substantially all Kalaeloa's activities are conducted on HECO's behalf [paragraph 4(h)(2)]. HECO does not provide equity, subordinated debt or other forms of subordinated financial support to Kalaeloa, therefore paragraph 4(h)(3) does not apply. Kalaeloa has indicated that its activities are not primarily securitizations, other forms of asset-backed financings, or single-lessee leasing arrangements, therefore paragraph 4(h)(4) does not apply.

In addition to the explicit scope exceptions stated, there is a section of FIN 46R that might be interpreted to be a scope exception for operating leases.[7] See discussion of lease accounting treatment of the contract in the following section.

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[6] FIN 46R, Appendix C, paragraph C3 states: "The definition of a business for use in this Interpretation is as follows: A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues. For a set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to conduct normal operations, which include the ability to sustain a revenue stream by providing its outputs to customers." Paragraph C6 states: "If all but a *de minimis* (say, 3 percent) amount of the fair value of the set of activities and assets is represented by a single tangible or identifiable intangible asset, the concentration of value in the single asset is an indicator that an asset rather than a business is being evaluated."

[7] FIN 46R, Appendix B, paragraph B24 states: "Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset's life that is covered by the lease. Most operating leases do not absorb variability in the fair value of an entity's net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the

<u>Information necessary to determine whether or not Kalaeloa is a VIE</u>

FIN 46R addresses consolidation by business enterprises of variable interest entities, which have one or more of the following characteristics: (paragraph 5)

a. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders.

b. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:

    1) The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights

    2) The obligation to absorb the expected losses of the entity

    3) The right to receive the expected residual returns of the entity.

c. The equity investors as a group also are considered to lack characteristic (b)(l) if (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (ii) substantially all of the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. For purposes of applying this requirement, enterprises shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all of that party's interests in the entity and not only to its equity investment at risk.

Without additional information on the Kalaeloa financial structure, its investors, and others who may participate in its financial structure, HECO would not be able to apply the requirements of FIN 46R, paragraph 5. HECO requires any information that would indicate that Kalaeloa activity is conducted on behalf of investors other than HECO that have disproportionately few voting rights. Additional information necessary to assess these criteria may include, amongst other information: amount of equity at risk by any party, ownership documents relating to voting or similar rights (e.g. Articles of Incorporation, partnership agreement), any documents addressing participation in losses or earnings of the entity (e.g. ownership agreements, debt and other borrowing documents).

<u>Assessment of whether or not the contract is a variable interest in a VIE</u>

If it is determined that Kalaeloa is a VIE, HECO must assess whether or not the contract is a variable interest in Kalaeloa.

Variable interests are contractual, ownership or other pecuniary interests in an entity that change with changes in the fair value of an entity's net assets exclusive of variable

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conditions described in paragraph 12 of this Interpretation. Alternatively, such arrangements may be variable interests in portions of a variable interest entity as described in paragraph 13 of this Interpretation."

interests.[8] Assets, liabilities, or other contracts with an entity that increase or cause the variability of the entity are not variable interests in the entity, whereas assets, liability, equity, or other contracts that absorb or receive the entity's variability are variable interests. The accounting under generally accepted accounting principles for an item does not determine whether the item is a variable interest.[9]

HECO must assess whether the contract creates or absorbs variability in the fair value of Kalaeloa's net assets, exclusive of the contract.

Information needed to determine whether or not HECO is the "primary beneficiary"

FIN 46R provides the following guidance to address which entity should consolidate the VIE (paragraph 14):

> "An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. An enterprise shall consider the rights and obligations conveyed by its variable interests and the relationship of its variable interests with variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both. If one enterprise will absorb a majority of a variable interest entity's expected losses and another enterprise will receive a majority of that entity's expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the variable interest entity."

In order to assess whether HECO is the primary beneficiary, HECO needs information of what other entities have potential economic interest in Kalaeloa, any "related party" relationships between the entities as defined under FIN 46R[10], and an understanding of how the interests are impacted by economic variability.

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[8] FIN46R Appendix B paragraph B2.

[9] KPMG Guide to Consolidation of Variable Interest Entities An Analysis of FASB Interpretation No. 46R dated February 2004, paragraph 3.004.

[10] FIN 46R, paragraphs 16 and 17 state: "16. For purposes of determining whether it is the primary beneficiary of a variable interest entity, an enterprise with a variable interest shall treat variable interests in that same entity held by its related parties as its own interests. For purposes of this Interpretation, the term *related parties* includes those parties identified in FASB Statement No. 57, *Related Party Disclosures,* and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. The following are considered to be de facto agents of an enterprise:

a. A party that cannot finance its operations without subordinated financial support from the enterprise, for example, another variable interest entity of which the enterprise is the primary beneficiary
b. A party that received its interests as a contribution or a loan from the enterprise
c. An officer, employee, or member of the governing board of the enterprise
d. A party that has (1) an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the enterprise or (2) a close business relationship like the relationship between a professional service provider and one of its significant clients. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a variable interest entity through the sale, transfer, or encumbrance of those interests.

HECO believes that potential losses that may be absorbed by other potential interests in Kalaeloa may include but are not limited to: capital expenditures, debt service (if any), operation of the plant, and environmental compliance. Potential losses that may be absorbed by HECO may include but are not limited to: electric price fluctuations and the commitment to take output of the facility under certain conditions. The information requirements to address this section of FIN 46R are very broad since HECO may not be aware of agreements or potential situations that could potentially create variability in Kalaeloa's interests.

Reassessment under FIN 46R

FIN 46R specifies situations under which the determination of whether Kalaeloa is a variable interest entity would need to be reassessed. Paragraph 7 of FIN 46R states that the initial determination of whether an entity is a variable interest entity shall be reconsidered if one or more of the following occur:

a. The entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk.
b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity.
c. The entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.
d. The entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses.

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17. If two or more related parties (including the de facto agents described in paragraph 16) hold variable interests in the same variable interest entity, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, then the party, within the related party group, that is most closely associated with the variable interest entity is the primary beneficiary. The determination of which party within the related party group is most closely associated with the variable interest entity requires judgment and shall be based on an analysis of all relevant facts and circumstances, including:

a. The existence of a principal-agency relationship between parties within the related party group
b. The relationship and significance of the activities of the variable interest entity to the various parties within the related party group
c. A party's exposure to the expected losses of the variable interest entity
d. The design of the variable interest entity."

The glossary of FAS 57 defines related parties as follows: "Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests."

FIN 46R specifies situations under which the determination of whether HECO is the primary beneficiary would need to be reassessed. Under FIN 46R paragraph 15, an enterprise with an interest in a variable interest entity shall reconsider whether it is the primary beneficiary of the entity if the entity's governing documents or contractual arrangements are changed in a manner that reallocates between the existing primary beneficiary and other unrelated parties (a) the obligation to absorb the expected losses of the variable interest entity or (b) the right to receive the expected residual returns of the variable interest entity. Also under FIN 46R paragraph 15, the primary beneficiary also shall reconsider its initial decision to consolidate a variable interest entity if the primary beneficiary sells or otherwise disposes of all or part of its variable interests to unrelated parties or if the variable interest entity issues new variable interests to parties other than the primary beneficiary or the primary beneficiary's related parties. A holder of a variable interest that is not the primary beneficiary also shall reconsider whether it is the primary beneficiary of a variable interest entity if that enterprise acquires additional variable interests in the variable interest entity.

These reassessment requirements create an ongoing need for information in order to comply with FIN 46R.

Information required to comply with SOX 404

HECO's assessment of Kalaeloa's internal controls over financial reporting will only be required in the event that it is determined that HECO must consolidate Kalaeloa. As it has not been determined that HECO does need to consolidate Kalaeloa, HECO has not determined what specific information would be required to comply with its assessment of internal controls to comply with SOX 404.

LEASE ACCOUNTING ISSUE

Background

For financial statement reporting purposes, a lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. Lease accounting addresses the issue of how a lease is accounted for financial reporting purposes. There are at least two parties to a lease arrangement: lessor and lessee. Generally, operating leases are accounted for as expenses by the lessee while the lessor would report the investment in assets, related depreciation expense and lease revenue. On the other hand, if the agreement is deemed a capital lease, a lessee would report an investment in asset, related depreciation, a capital lease obligation and related interest expense.

In order to determine the applicability of lease accounting to a PPA, it must first be determined whether the PPA is a lease. In May 2003, EITF issued EITF Issue No. 01-8 "Determining Whether an Arrangement Contains a Lease." EITF 01-8 defines a lease as an agreement that conveys the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

If it is determined that a PPA is a lease, it must be determined to be either a capital lease or an operating lease. The primary source of accounting guidance as to whether a lease is a capital lease or an operating lease is Statement of Financial Accounting Standards No. 13 "Accounting for Leases" (FAS 13).

Information needed to determine whether or not the PPA is a lease

EITF 01-8 states that an arrangement conveys the right to use property, plant, or equipment ("PPE") if any one of the following conditions is met: (paragraph 12)

a. The purchaser has the ability or right to operate the PPE while obtaining or controlling more than a minor amount of the output or other utility of the PPE,

b. The purchaser has the ability or right to control physical access to the underlying PPE while obtaining or controlling more than a minor amount of the output or other utility of the PPE, or

c. Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the PPE during the term of the arrangement, and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

HECO would not have the ability or right to operate the Kalaeloa facility, therefore test (a) would not be met. HECO would not have the ability or right to control physical access to the Kalaeloa facility, therefore test (b) would not be met. HECO determined that Tesoro takes more than 12% of the thermal output of the facility (measured in BTU), therefore a party other than HECO takes more than a minor amount of the output. Further, the price for the output is not contractually fixed per unit of output and not equal to the current market price at the time of delivery of the output. Therefore, test (c) is not met.

In addition to determining that the Kalaeloa facility currently sells more than a minor amount of its output to Tesoro, the following provision was included in Amendment 5:

24.1 The Facility shall for each Calendar Year beginning with the Calendar Year in which the Increment One Capacity In-Service Date occurs achieve an Operating Thermal Threshold greater than or equal to the Minimum Thermal Threshold. Within thirty (30) days after the end of each Calendar Year, Kalaeloa shall provide HECO with a written report documenting the Operating Thermal Threshold actually achieved by Kalaeloa during such Calendar Year and a copy of the annual notice filed by Kalaeloa pursuant to 18 CFR Part 292 demonstrating that the Facility is a Qualifying Facility.

1.86 Operating Thermal Threshold – The ratio, for the Calendar Year in question, of the Facility's useful thermal output for such Calendar Year divided by the sum of (i) the useful electrical output for such Calendar Year plus (ii) the useful thermal output for such Calendar Year. This ratio is to be expressed as a percentage.

1.80 Minimum Thermal Threshold – For any Calendar Year, shall be an Operating Thermal Threshold of twelve percent (12%), provided, however, that in the event that HECO determines, in its sole discretion, that the Power Purchase Agreement is likely to be deemed to be an arrangement containing a lease within the scope of Financial Accounting Standards Board ("FASB") Statement No. 13, Accounting for Leases, by reason of the Minimum Thermal Threshold being 12%, then the Minimum Thermal Threshold shall upon written notice by HECO to Kalaeloa be increased to an Operating Thermal Threshold of fifteen percent (15%) for the next Calendar Year and subsequent years.

Since none of the tests are met, the Kalaeloa contract is not deemed a lease. Since the contract is not deemed a lease, evaluation of whether the lease is a capital lease or operating lease is not required.

<u>Reassessment under EITF 01-8</u>

Under EITF 01-8 (paragraph 13), assessment of whether an arrangement contains a lease should be made at inception of the arrangement. Further, a reassessment of whether the arrangement contains a lease shall be made only if (a) there is a change in the contractual terms, (b) a renewal option is exercised or an extension is agreed to by the parties to the arrangement, (c) there is a change in the determination as to whether or not fulfillment is dependent on specified PPE, or (d) there is a substantial physical change to the specified PPE. The reassessment of an arrangement should be based on the facts and circumstances as of the date of reassessment, therefore there is an ongoing need for information to reassess the applicability of lease accounting treatment for the PPA.

Accounting Reference Summaries

- Financial Accounting Standards Board Interpretation No. 46 "Consolidation of Variable Interest Entities – an interpretation of ARB No. 51" (revised December 2003) ("FIN 46R")
- Emerging Issues Task Force Issue No. 04-7 ""Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity" ("EITF 04-7")
- Emerging Issues Task Force Issue No. 01-8 "Determining Whether an Arrangement Contains a Lease" ("EITF 01-8")
- Statement of Financial Accounting Standards No. 13 "Accounting for Leases" ("FAS 13")
- Statement of Financial Accounting Standards No. 29 "Determining Contingent Rentals, an amendment of FASB Statement No. 13" ("FAS 29")

Summary of Interpretation No. 46 (revised December 2003)

Consolidation of Variable Interest Entities—an interpretation of ARB No. 51(Issued 12/03)

This Interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, which replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* addresses consolidation by business enterprises of variable interest entities, which have one or more of the following characteristics:

a. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders.

b. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:

    1) The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights

    2) The obligation to absorb the expected losses of the entity

    3) The right to receive the expected residual returns of the entity.

c. The equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

The following are exceptions to the scope of this Interpretation:

1. Not-for-profit organizations are not subject to this Interpretation unless they are used by business enterprises in an attempt to circumvent the provisions of this Interpretation.

2. Employee benefit plans subject to specific accounting requirements in existing FASB Statements are not subject to this Interpretation.

3. Registered investment companies are not required to consolidate a variable interest entity unless the variable interest entity is a registered investment company.

4. Transferors to qualifying special-purpose entities and "grandfathered" qualifying special-purpose entities subject to the reporting requirements of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* do not consolidate those entities.

5. No other enterprise consolidates a qualifying special-purpose entity or a "grandfathered" qualifying special-purpose entity unless the enterprise has

the unilateral ability to cause the entity to liquidate or to change the entity in such a way that it no longer meets the requirements to be a qualifying special-purpose entity or "grandfathered" qualifying special-purpose entity.

6. Separate accounts of life insurance enterprises as described in the AICPA Auditing and Accounting Guide, *Life and Health Insurance Entities,* are not subject to this Interpretation.
7. An enterprise with an interest in a variable interest entity or potential variable interest entity created before December 31, 2003, is not required to apply this Interpretation to that entity if the enterprise, after making an exhaustive effort, is unable to obtain the necessary information.
8. An entity that is deemed to be a business (as defined in this Interpretation) need not be evaluated to determine if it is a variable interest entity unless one of the following conditions exists:
    a. The reporting enterprise, its related parties, or both participated significantly in the design or redesign of the entity, and the entity is neither a joint venture nor a franchisee.
    b. The entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting enterprise and its related parties.
    c. The reporting enterprise and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the entity based on an analysis of the fair values of the interests in the entity.
    d. The activities of the entity are primarily related to securitizations, other forms of asset-backed financings, or single-lessee leasing arrangements.
9. An enterprise is not required to consolidate a governmental organization and is not required to consolidate a financing entity established by a governmental organization unless the financing entity (a) is not a governmental organization and (b) is used by the business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation.

Reason for Issuing This Interpretation

Transactions involving variable interest entities have become increasingly common, and the relevant accounting literature is fragmented and incomplete. ARB 51 requires that an enterprise's consolidated financial statements include subsidiaries in which the enterprise has a controlling financial interest. That requirement usually has been applied to subsidiaries in which an enterprise has a majority voting interest, but in many circumstances the enterprise's consolidated financial statements do not include variable interest entities with which it has similar relationships. The voting interest approach is not effective in identifying controlling financial interests in entities that are not controllable through voting interests or in which the equity investors do not bear the residual economic risks.

The objective of this Interpretation is not to restrict the use of variable interest entities but to improve financial reporting by enterprises involved with variable interest entities. The Board believes that if a business enterprise has a controlling financial interest in a variable interest entity, the assets, liabilities, and results of the activities of the variable interest entity should be included in consolidated financial statements with those of the business enterprise.

Differences between This Interpretation and Current Practice

Under current practice, two enterprises generally have been included in consolidated financial statements because one enterprise controls the other through voting interests. This Interpretation explains how to identify variable interest entities and how an enterprise assesses its interests in a variable interest entity to decide whether to consolidate that entity. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed.

An enterprise that consolidates a variable interest entity is the primary beneficiary of the variable interest entity. The primary beneficiary of a variable interest entity is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets excluding variable interests. An enterprise with a variable interest in a variable interest entity must consider variable interests of related parties and de facto agents as its own in determining whether it is the primary beneficiary of the entity.

Assets, liabilities, and noncontrolling interests of newly consolidated variable interest entities generally will be initially measured at their fair values except for assets and liabilities transferred to a variable interest entity by its primary beneficiary, which will continue to be measured as if they had not been transferred. However, assets, liabilities, and noncontrolling interests of newly consolidated variable interest entities that are under common control with the primary beneficiary are measured at the amounts at which they are carried in the consolidated financial statements of the enterprise that controls them (or would be carried if the controlling entity prepared financial statements) at the date the enterprise becomes the primary beneficiary. Goodwill is recognized only if the variable interest entity is a business as defined in this Interpretation. Otherwise, the reporting enterprise will report an extraordinary loss for that amount. After initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated variable interest entity will be accounted for as if the entity was consolidated based on voting interests. In some circumstances, earnings of the variable interest entity attributed to the primary beneficiary arise from sources other than investments in equity of the entity.

An enterprise that holds significant variable interests in a variable interest entity but is not the primary beneficiary is required to disclose (1) the nature, purpose, size, and activities of the variable interest entity, (2) its exposure to loss as a result of the variable interest holder's involvement with the entity, and (3) the nature of its involvement with the entity and date when the involvement began. The primary beneficiary of a variable interest entity is required to disclose (a) the nature, purpose, size, and activities of the variable interest entity, (b) the carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations, and (c) any lack of recourse by creditors (or beneficial interest holders) of a consolidated variable interest entity to the general credit of the primary beneficiary.

How This Interpretation Will Improve Financial Reporting

This Interpretation is intended to achieve more consistent application of consolidation policies to variable interest entities and, thus, to improve comparability between enterprises engaged in similar activities even if some of those activities are conducted through variable interest entities. Including the assets, liabilities, and results of activities of variable interest entities in the consolidated financial statements of their primary beneficiaries will provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprise. Disclosures about variable interest entities in which an enterprise has a significant variable interest but does not consolidate will help financial statement users assess the enterprise's risks.

How the Conclusions in This Interpretation Relate to the Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that is useful in making business and economic decisions. Including variable interest entities in consolidated financial statements with the primary beneficiary will help achieve that objective by providing information that helps in assessing the amounts, timing, and uncertainty of prospective net cash flows of the consolidated entity.

Completeness is identified in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* as an essential element of representational faithfulness and relevance. Thus, to represent faithfully the total assets that an enterprise controls and liabilities for which an enterprise is responsible, assets and liabilities of variable interest entities for which the enterprise is the primary beneficiary must be included in the enterprise's consolidated financial statements.

FASB Concepts Statement No. 6, *Elements of Financial Statements,* defines *assets,* in part, as probable future economic benefits obtained or controlled by a particular entity and defines *liabilities,* in part, as obligations of a particular entity to make probable future sacrifices of economic benefits. The relationship between a variable interest entity and its primary beneficiary results in control by the primary beneficiary of future benefits from the assets of the variable interest entity even though the primary beneficiary may not have the direct ability to make decisions about the uses of the assets. Because the liabilities of the variable interest entity will require sacrificing consolidated assets, those liabilities are obligations of the primary beneficiary even though the creditors of the variable interest entity may have no recourse to the general credit of the primary beneficiary.

The Effective Date of This Interpretation

Special provisions apply to enterprises that have fully or partially applied Interpretation 46 prior to issuance of this Interpretation. Otherwise, application of this Interpretation (or Interpretation 46) is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities (other than small business issuers) for all other types of entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other than special-purpose entities and by nonpublic entities to all types of entities is required at various dates in 2004 and 2005. In some instances, enterprises have the option of applying or continuing to apply Interpretation 46 for a short period of time before applying this Interpretation.

Summary of EITF Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity"

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* provides guidance on how to apply the controlling financial interest criteria in AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* to variable interest entities (VIEs). VIEs are evaluated for consolidation based on all contractual, ownership, or other interests that expose their holders to the risks and rewards of the entity. These interests are termed variable interests. An integral part of applying Interpretation 46(R) is determining whether interests are variable interests. Constituents have raised concerns that Interpretation 46(R) is unclear as to how an entity should determine whether a contract absorbs variability. Different approaches for making this determination have developed, which results in inconsistent identification of interests as variable interests. These inconsistencies can have a significant impact on the determination as to which party should consolidate the VIE. The issue is what variability should be considered when determining whether an interest is a variable interest.

Status: This Issue will be discussed further at a future meeting
Last discussed: June 30-July 1, 2004

Summary of EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease"

Paragraph 1 of FASB Statement no. 13, *Accounting for Leases,* defines a lease as "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." It goes on to state that agreements that transfer the right to use property, plant, or equipment meet the definition of a lease even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. There are divergent views and practices as to how to identify al lease in an arrangement that also provides for deliver of other goods or services by the seller (lessor). This Issue was originally raised by the Task Force during its deliberations on the accounting for energy trading activities. However, the issue of whether an arrangement contains a lease is not unique to enrgy-related contracts. The same issue may arise in outsourcing arrangements, such as the outsourcing of the data processing functions of an enterprise (it may be a significant element, particularly in those arrangements that require a substantial investment in computer hardware and terminals devoted solely to the use of a single customer); in the telecommunications industry where providers of network capacity (primarily in the form of conduit, fiber optic cables, and related equipment) often grant rights to capacity on the basis of an indefeasible right of use; and in some take-or-pay contracts involving certain commodities. The Issue is how to determine whether an arrangement contains a lease that is within the scope of Statement 13.

Consensus was ratified on May 28, 2003.

Summary of Statement No. 13 "Accounting for Leases" (Issued 11/76)

This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For lessees, a lease is a financing transaction called a capital lease if it meets any one of four specified criteria; if not, it is an operating lease. Capital leases are treated as the acquisition of assets and the incurrence of obligations by the lessee. Operating leases are treated as current operating expenses. For lessors, a financing transaction lease is classified as a sales-type, direct financing, or leveraged lease. To be a sales-type, direct financing, or leveraged lease, the lease must meet one of the same criteria used for lessees to classify a lease as a capital lease, in addition to two criteria dealing with future uncertainties. Leveraged leases also have to meet further criteria. These types of leases are recorded as investments under different specifications for each type of lease. Leases not meeting the criteria are considered operating leases and are accounted for like rental property.

Summary of Statement No. 29 "Determining Contingent Rentals- an amendment of FASB Statement No. 13" (Issued 6/79)

The Board has been asked to reconsider the definition of contingent rentals in *FASB Statement No. 13,* "Accounting for Leases," because differing views about the meaning of that definition result in similar leases being accounted for differently, for example, as a capital lease by one lessee and as an operating lease by another lessee. This Statement defines contingent rentals as the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors on which lease payments are based. Lease payments that depend on a factor that exists and is measurable at the inception of the lease, such as the prime interest rate, would be included in minimum lease payments based on the factor at the inception of the lease. Lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue.

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EEI EDISON ELECTRIC INSTITUTE

March 16, 2004

Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: Implementation Guidance for FASB Interpretation No. 46 (revised December 2003)

Dear Mr. Herz:

Edison Electric Institute ("EEI") is the association of United States investor-owned electric utilities, international affiliates and industry associates worldwide. Its United States members serve more than 90 percent of the ultimate customers in the shareholder-owned segment of the industry. They generate almost 70 percent of all the electricity generated by electric companies in the country and service about 70 percent of all ultimate customers in the nation.

EEI member companies have become aware that members of the FASB staff and representatives from several of the Big Four accounting firms have recently discussed implementation issues regarding FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51* (FIN 46R). We understand that some of the preliminary views expressed during those 2004 discussions suggest that certain contractual relationships, specifically, various types of power purchase agreements (including "tolling" contracts[1]) that are common in the energy industry, would be considered to be variable interests under FIN 46R.

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[1] Under a *tolling contract,* a company enters into an agreement with a third-party owner of a power-generating plant, whose power-generating plant converts natural gas into electricity. Under the agreement, the company acquires the right, but not the obligation, to utilize the conversion services of the power-generating plant for a fixed price for a fixed period of time. The company owns the natural gas supplied and the electricity produced; the owner of the power-generating plant is responsible under the agreement for the process of converting natural gas to electricity. [Paragraph 3, Emerging Issues Task Force (EITF) Issue No. 00-17, *Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10*, superseded by EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*.]

Our industry enters into a broad variety of such contracts in the normal course of business for purchasing and selling our most basic product on normal commercial terms. A significant impact on our industry would result if application of FIN 46R to these contractual relationships requires de-consolidation of entities that are legally owned, managed and controlled through voting rights, or if consolidation is required for non-affiliated entities that provide long-term supplies of electric capacity and energy. Accordingly, EEI submits this letter in order to provide our views on the application of FIN 46R to power purchase agreements and tolling agreements. **Unless indicated otherwise, throughout this letter, we use the term "power purchase agreement" broadly to refer to forward or tolling contracts for the purchase of power from an entity that owns a power plant capable of generating electricity.**

Summary of EEI Views

EEI is aware of developing interpretations of certain provisions of FIN 46R that we believe are overly broad and fail to take into account other relevant considerations. We also are extremely concerned about the impact of these matters on our ability to implement the interpretation. In summary, EEI and its member companies believe that:

- A contract to purchase electricity is not equivalent to a contract for the sale or ownership of a power plant;
- Power purchase agreements that are forward contracts may be eligible for the application of paragraph B12 of FIN 46R;
- Tolling contracts (and similar arrangements) are not, by definition, variable interests in the owner of the power plant, and the existence of a tolling contract does not necessarily indicate that the power plant owner is a variable interest entity; and,
- The fact that guidance is being developed on the application of FIN 46R to power purchase and tolling agreements less than a month before the required implementation of that interpretation necessitates a delay in the application of FIN 46R for such agreements (and possibly for other industries that sell the output of production facilities under long-term contracts).

We discuss each of these important matters below. We understand that the FASB may provide guidance with respect to the application of certain aspects of FIN 46R to power purchase agreements, and we respectfully request the staff to consider our views on these matters in developing that guidance.

Contracts to Purchase Power Are Not Contracts to Purchase a Power Plant

EEI understands that some have expressed a view equating a power purchase agreement with a contract to purchase the facility that is capable of producing the power, or, stated differently, that owning a power plant is equivalent to owning the electricity that the plant has the potential to produce. EEI strongly believes that this view is not correct. While the ownership of a power plant and a contract for the output of the plant share certain economic characteristics, primarily commodity price risk, there are also substantial differences between the two. Power plants are capital-intensive manufacturing facilities that have the capability, when and if operated, to produce electricity, while a contract to purchase electricity is essentially a commodity contract that is substantively different from ownership of the power plant itself. We strongly believe that it is inappropriate to categorize a power purchase agreement as a contract for the purchase of a power plant in substance or to view power plant ownership as equivalent to ownership of electricity.

Unique Risks of Owning a Production Facility

Owning a facility that represents the capacity to produce other assets is not the same as owning the assets that may be produced. A facility only provides the potential capacity to produce assets and must be combined with other inputs, e.g., materials, labor and management, during the execution of processes in order to produce assets. Risks and rewards are inherent in production processes, and those risks distinguish the economic substance of ownership and control of a production facility from that of a contract for the output of that facility.

For example, ownership of an airplane manufacturing facility is not equivalent to a contract to purchase airplanes, nor does a contract to purchase airplanes represent control over that factory. Similarly, ownership of a farm is not equivalent to a contract for the grain that the farm can produce, and a contract to purchase grain does not render the purchaser economically equivalent to a farmer. In both cases, substantial processes must be brought to bear by the owner/operator of the "facility" to produce the product, and unforeseen circumstances may interrupt, delay, or even terminate the production process. While the economic benefit derived from both the facility and the contract for its output may be similar, particularly in the short term, contracts for the output of these facilities do not reflect or transfer the costs and risks associated with those processes employed to produce the product, and facility ownership is not equivalent to ownership of the product.

We believe that, similar to these and other examples, ownership of a power plant is not equivalent to a contract for the electricity that plant can generate. Electricity must be produced as needed – it cannot be stored and therefore must be generated through the continuous operation of manufacturing facilities (power plants) that are subject to operational, financial, and other costs and risks not present in electricity commodity contracts. Specifically, ownership of a power plant involves the assumption of numerous risks beyond commodity prices, including responsibility for operations and maintenance costs, mechanical operating and other production decisions and risks, determinations regarding the timing, amount and funding of capital expenditures to maintain, expand, or improve the efficiency of production, financing arrangements and debt service, compliance with environmental regulations and risks of environmental damage, physical damage to the plant, and legal and regulatory obligations for asset retirement and removal.

From an operational perspective, power plants are complex manufacturing facilities that can and do experience unplanned shut-downs. Examples of common operational events that may cause unplanned shut-downs of power plants include:

- Boiler leaks
- Problems with critical cooling equipment
- Nuclear safety issues of any kind
- Turbine breakdowns
- Transformer breakdowns
- Power distribution system outages or disturbances
- Catastrophic mechanical damage.

From a cost perspective, fuel is only one, and perhaps the least complex, component of the cost of generating electricity. Power plant owners are exposed to variability in many other costs beyond fuel costs, including:

- Environmental compliance costs, including emissions allowances
- Labor costs
- Costs of materials, supplies, and equipment for maintenance
- Capital expenditures to maintain, expand or improve efficiency of production
- Property taxes
- Asset retirement costs.

Contrasting Risks of a Commodity Contract
A contract for the sale of electricity typically transfers only the electricity price risk or, in the case of a tolling contract, the electricity and fuel price risk. If the contract is executed at market price, the fair value of that contract is zero at the time of execution, and any variability in the fair value of the contract would be determined by comparing market prices to the contract price. Even if the contract is contingent upon the operation of the facility, the exposure of the

purchaser is limited to commodity price risk.

Alternatively, the owner of the plant, even after executing such a contract, retains all of the other risks enumerated above, as well as the variability in those risks and variability in the difference between the contract price and the marginal cost of production. If the plant is not capable of operating, the owner of that plant may have to compensate the purchaser of power for failure to deliver, thus creating variability for the entity, not absorbing it.

Other Examples in Related Literature

The principles underlying paragraph B 24 of FIN 46R support this view. That paragraph states that operating leases do not absorb variability in the fair value of an entity's assets because they are a component of that variability (unless they contain a residual value guarantee or an option to acquire the leased asset). Under EITF 01-8, power purchase agreements must be evaluated for potential lease accounting treatment and must be accounted for as such if the agreement transfers the right to use the underlying power plant by meeting the criteria in that consensus. While an operating lease transfers the benefits available from leased assets, it is not equivalent to transferring the asset. If a power purchase agreement does not meet the criteria of EITF 01-8 for classification as a lease (evidencing the right to use an asset), in our view, such a power purchase agreement cannot be equivalent to a contract to purchase the power plant.

When considering a related issue in EITF 02-3, the Emerging Issues Task Force distinguished the accounting for energy trading contracts between those contracts that meet the criteria of SFAS 133 to be a derivative (i.e., those that essentially make the holder of the contract indifferent to physical versus financial settlement) and those contracts that do not because they embody a requirement to perform a service or deliver a product. Typically, the types of power purchase contracts that are not derivatives are those contracts that require future performance; as a result, mark-to-market accounting is prohibited because those contracts are not in substance the same as derivatives, including lacking the characteristics of a defined notional and net settlement. Just as the Task Force deemed that a substantive difference exists between contracts that are derivatives and those that are not, similarly a contract for the purchase of a commodity is substantively different from a contract for the purchase of the facility that must be operated to produce that commodity.

Power Purchase Agreements May Be Eligible for Application of Paragraph B12

EEI believes that forward contracts to sell electricity may be eligible for application of the provisions of paragraph B12 of FIN 46R and, if so, would not be considered variable interests under the interpretation (assuming that those agreements have first been evaluated under EITF 01-8 and do not meet the criteria for classification as a lease, and further assuming that those agreements do not contain other terms that evidence a variable interest under other provisions of FIN 46R).

Many EEI companies have applied paragraph B12[2] of FIN 46R in evaluating power purchase agreements associated with power plants where the company either

- Owns and operates a power plant, or
- Purchases power from another entity that owns and operates a power plant.

EEI believes this application is appropriate and consistent with the objective of FIN 46R because a forward power purchase agreement in which the seller of electricity owns and operates a power plant creates, rather than absorbs, variability because the seller does not own the asset, i.e., the electricity, that is the subject of the contract at inception. While a fixed-price forward electricity contract may transfer a portion of the commodity price risk associated with a power plant, as described earlier, substantial differences remain between a contract for the purchase of electricity and the ownership of a power plant.

A fixed-quantity contract creates variability because it imposes a requirement on the power plant operator to supply electricity whether or not the power plant can operate. The plant owner remains exposed to all of the risks and variability associated with owning and operating that plant. Although the contract mitigates the exposure to electricity price risk at the time the electricity is generated, if the contract includes an obligation to make the buyer of electricity whole in the event of nonperformance, the seller remains exposed to variability in electricity prices until and unless it actually produces electricity. If the plant did not operate, the seller would have to resort to market purchases or compensate the buyer at market prices, in either event exposing the seller to commodity price risk.

Similarly, a unit-contingent quantity contract creates variability by imposing the requirement to supply electricity by operating the plant in order to be compensated for its services. Just as with the fixed-quantity contract, commodity price risk is transferred only to the extent that the plant operates and electricity is actually delivered. However, if the plant cannot operate, not only has the seller failed to transfer commodity price risk but also may have to forego all or a portion of its compensation for operating the plant without the potential to benefit from

[2] B12. Forward contracts to buy assets or to sell assets that are not owned by the entity at a fixed price will usually expose the entity to risks that will increase the entity's expected variability. Thus, most forward contracts to buy assets or to sell assets that are not owned by the entity are not variable interests in the entity.

supplying the electricity from the market (if market prices have fallen below the contract price).

EEI believes that the above examples illustrate how forward power purchase contracts with entities that own a power plant are eligible for application of the criteria of paragraph B12 of FIN 46R. The following table summarizes the risks retained under both fixed quantity and unit-contingent (requirements) power purchase agreements as described above.

Risk	Fixed Quantity Contract		Unit-Contingent Quantity Contract	
	Seller	Buyer	Seller	Buyer
Commodity price	[a]	X		X [b]
Physical operations	X		X	
Operations/maintenance costs	X		X	
Capital expenditures	X		X	
Scheduling and delivery	X		X	
Debt service	X		X	
Environmental compliance	X		X	
Environmental contamination	X		X	
Physical damage/risk of loss	X		X	

[a] Risk retained if contract requires seller to make buyer whole for damages in event of nonperformance.
[b] Only to the extent that the plant is operated and power is actually delivered.

<u>Tolling Contracts Are Not, by Definition, Variable Interests</u>

We understand that a view has emerged that tolling contracts (and similar agreements under which the purchaser of electricity pays a fuel-based pass-through cost rather than physically providing the fuel) cause an entity to be considered a VIE under paragraph 5b(2). Contrary to this view, these types of arrangements are not, by definition, variable interests in the entity providing the tolling services. Furthermore, the existence of a tolling contract or similar arrangement does not necessarily indicate that the seller is a variable interest entity.

Like all power generating facilities, power plants that are under contract to perform tolling services are complex manufacturing facilities that can and do experience unplanned shut-downs. Although owners of tolling facilities are not exposed to variability in fuel costs, they are generally exposed to the variability in all other ownership and production costs – the same as those described earlier for power generating facilities. As with a unit-contingent forward contract, tolling agreements transfer commodity price risk only to the extent that electricity is generated and actually delivered. Further, many tolling arrangements only result in the generation of electricity when requested by the customer. So the primary function of a facility under a tolling contract is to be available to generate electricity when requested.

For plants under tolling contracts, typically the form of the contract under which the plant's output is sold was not, by design, intended to shield its equity interests from variability in the plant's assets. Providing conversion services to those who need a variable quantity of electricity is the principal purpose of a tolling contract, thereby enabling the facility owner to earn capacity and other revenue to recover its operating costs and capital investment, to pay debt service, to repay debt and to provide its owners/equity investors an opportunity to earn a reasonable rate of return. While pricing terms in tolling arrangements may vary, the most significant component of revenue for many tolling arrangements is comprised of capacity revenue. Similar to an operating lease receivable, the capacity sales component of a tolling contract is a nonvariable interest *from the perspective of the selling entity*. Those capacity payments are not linked to and do not explicitly reduce or transfer variability in the operating and other costs of a power plant used for tolling services. In light of the operational risks retained, the owners' equity investment in an entity that provides tolling services is exposed to, and is obligated to absorb, the entity's expected losses. In addition, no other party has a right to receive the entity's expected residual returns.

Determining whether a tolling contract is a variable interest requires an economic analysis of the rights and obligations under the contract *from the perspective of the selling entity*. In order to support the view that a tolling contract is a variable interest, one must assert that the tolling arrangement is in substance something other than a normal course sale of electricity, artificially attribute the cost of fuel and related variability to the entity that is providing tolling services rather than the purchaser (which agreed to assume that cost at inception of the contract), and converting the fuel into electricity. We believe this ignores qualitative factors that should be considered in the determination of whether a tolling entity represents a variable interest entity.

Operators of power plants continually make decisions about how much of their anticipated fuel usage to hedge and how much of their power output to hedge. These are normal aspects of managing the commodity price risks of a power plant. We do not believe it is an appropriate interpretation of FIN 46R to conclude that an entity is a VIE simply because of the way it chooses to manage its raw material and output price risks. Few equity investors would invest in a power plant that did not attempt to mitigate normal risks, including managing fuel input and power output price risks either through gas and electricity contracts with separate parties or through a tolling agreement (or similar arrangement) that accomplishes the same goal but with one party. If one accepts that mitigating these risks triggers VIE status under paragraph 5b(2) in that they absorb risks that the equity holder would have otherwise absorbed, then the logical extension of that interpretation is that any hedging of risks by a single plant entity (whether in our industry or others) absorbs risks on behalf of the equity holders; therefore generally causing all such entities to be VIEs even though the risks being managed were normal business risks. Given the focus on qualitative assessment in FIN 46R and the ills that FIN 46 and FIN 46R were attempting to address, we do not think it is generally appropriate to view purchase and sale contracts (whether with one party or many) as arrangements crafted to absorb risks from the equity holders if they represent normal business risk management for such entities (as opposed to say a residual value guarantee or written put option). Such determination would be a judgmental one based on the facts and circumstances of each relationship, as is appropriate for a principles based standard.

Lack of Timely Guidance Necessitates a Delay in Application of FIN 46R

New Consolidation Model and Continually Emerging Guidance

The FIN 46R model introduced new complexity into the consolidation model that has not been easily recognized nor readily understood. The late date at which the industry became aware that the FASB staff was considering the potential issues addressed in this letter and the fact that several of the major accounting firms have recently been engaged in efforts to develop guidance on these issues merely two weeks before the required implementation date are both indicators of the level of complexity involved and the difficulty in applying the provisions of FIN 46R.

The amount of time between the issuance of the interpretation and the effective date has not been conducive for a thorough evaluation of the interpretation's requirements, which differ in substantive respects and details of implementation from the originally issued FIN 46. We recognize and appreciate that, in mid-December 2003, the Board provided an additional three months to implement FIN 46R with respect to entities that are not "special purpose entities." Unfortunately, for calendar-year companies, this additional period coincided with the year-end close, analysis and reporting of 2003 results, and the preparation and filing of annual reports to shareholders and with regulatory agencies.

EEI member companies are currently evaluating contractual relationships in preparation for the required adoption of FIN 46R on March 31, 2004. For some EEI member companies, this is a massive effort. For example, one EEI member company may have to evaluate over 240 power purchase agreements with independent power producers, agreements which the company was required to execute under Federal energy legislation enacted many years ago. If the FASB staff issues guidance, or concurs with guidance developed by the major accounting firms, that requires the evaluation of power purchase agreements and tolling agreements under FIN 46R, we believe it will be extremely difficult for our member companies to implement the interpretation by March 31, 2004.

With the effective date applicable to special purpose entities now past, EEI and its member companies believe the objective of the FIN 46 project - to satisfy the urgent demand for remedial changes associated with special purpose entities - should have already been substantially satisfied with the completed evaluation of special purpose entities. In order to avoid potential disruption in financial reporting, EEI member companies, and potentially other industries who purchase or sell products or services under long-term contracts, need more time to properly implement this interpretation. Accordingly, EEI and its member companies respectfully request that the Board consider a delay in the effective date of FIN 46R at least until June 30, 2004 with respect to the interpretation's application to relationships that are based on long-term contracts to purchase or sell products or services.

Sarbanes-Oxley and Other Considerations
Moreover, the potential consequences that could result from hurried efforts to meet the March 31, 2004 effective date impose risks under the Sarbanes-Oxley Act of 2002. EEI member companies are concerned about the potential consolidation of entities that are not subject to control or over which significant influence may not be exercised. Such impacts could include difficulty both (a) in determining whether a material change in internal controls over financial reporting has occurred as a result of such consolidation, requiring reporting in Form 10-Q during 2004 and (b) in assessing and reporting on internal controls under Section 404 of the Act by the end of 2004.

EEI member companies anticipate that any "new" consolidation of suppliers or de-consolidation of subsidiaries resulting from FIN 46R will require incremental disclosures to facilitate meaningful financial analysis. Debt to capital, the relationship between revenues and gross margin, and interest coverage ratios are important metrics used by analysts and others to evaluate our industry's performance and financial health. While those entities consider energy companies' commitments under purchase obligations in evaluating our obligations, consolidation of power plants and related debt (along with associated interest costs) merely because of the existence of power purchase agreements (and deconsolidation by the legal owners responsible for debt service) would render our industry's financial statements less transparent and less useful by investment analysts, creditors, and others, particularly when such facilities are not capitalized under existing lease accounting requirements presumably because they do not transfer the risks and rewards of ownership of the underlying assets.

We sincerely appreciate this opportunity to provide this information and express our concerns to the Board. If you require additional information, or if you determine a meeting with industry representatives would facilitate resolution of any of these issues, please feel free to contact me at (202) 508-5527 or David Stringfellow at (202) 508-5494.

Sincerely,

David K. Owens
Executive Vice President
Business Operations

DKO:kk

cc: Mr. Lawrence Smith - Financial Accounting Standards Board
Director – Technical Application & Implementation Activities