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Strengthening Energy Efficiency Programs Through Decoupling in the Electric Sector

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Please direct questions regarding this report to Miles Keogh, NARUC's Director of Grants & Research, mkeogh@naruc.org; (202) 898-2200.

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Project Summary

Review of Initial Decoupling Filings for the Public Utilities Commission of Hawaii

NARUC Project No: Recovery Act Award DE-OE00000123;
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Consulting Agreement No: NARUC-2011-105-DE0123

Project Title: Capacity Assistance to the State of Hawaii in
Strengthening Energy Efficiency Programs in the
Electric Sector

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HAIKU DESIGN & ANALYSIS
4234 Hana Hwy.,
Haiku, HI., 96708
(808) 572-2519

Haiku Design & Analysis was retained by NARUC as a consultant to assist the Public Utilities Commission of Hawaii (Commission) with the initial review of recently approved, innovative “decoupling” rate designs. The project addressed the need for the Commission to review and approve the first tariff filings incorporating several new and complex decoupling mechanisms in a short period of time.

Background

In its Final Decision and Order, dated August 31, 2010 in Docket No. 2008-0274 (Decoupling Final D&O), the Commission approved several innovative rate design mechanisms for the Hawaiian Electric Company, Inc., Hawaii Electric Light Company, Inc. and Maui Electric Company, Limited (collectively: HECO Companies). The new rate design mechanisms are implemented by a set of tariffs. Provisions include:

- A revenue balancing account (RBA) which functions as a revenue decoupling mechanism. The RBA tariff adjusts effective rates to ensure that recovered revenues ultimately match authorized target revenues.
- A “Revenue Adjustment Mechanism” (RAM) that annually adjusts authorized target revenues. Authorized revenues for expenses are increased by labor and non-labor escalation factors. Authorized return on invested capital is adjusted for increases in ratebase, changes in depreciation and deferred amortization and income taxes.
- An “Evaluation Period Earnings Sharing” (EPES) mechanism that returns to ratepayers incremented fractions of any annual utility earnings on equity that are above target earnings established in the most recent rate case.
- Modifications to the HECO Companies’ existing automatic energy cost adjustment (ECAC) mechanisms. A “deadband” mechanism is implemented to delink utility net revenues from impacts of dispatch of variable renewable generation on system operation efficiency.

In accordance with the Decoupling Final D&O, the implementation of these mechanisms (collectively, Decoupling Mechanism) will commence for each of the HECO Companies corresponding with a subsequent general rate case for each company. The first decoupling tariffs became effective on March 1, 2011, corresponding to the Final D&O in the general rate case for Hawaiian Electric Company, Inc. (HECO): Docket No. 2008-0083 (Test Year 2009).

The first decoupling tariff implementation filing (that is the subject of this review) was made on March 31, 2011. In accordance with the terms of the decoupling tariffs, the Commission needed to review the decoupling tariff filing within a two month time frame, prior to the scheduled effective date of the proposed tariff amendments on June 1, 2011.

Project Phases

The project was executed in three phases:

Task 1: Preparation for Filing Review Process Task 1 of the decoupling review project was preparation for the time-constrained review of the initial decoupling tariff filing. Task 1 included

prior review of the Decoupling Mechanism, examination of the key issues expected in the initial tariff filings and planning and establishing a review process.

Task 2: Execution of Review of Initial Decoupling Tariff Filing Task 2 of the project was providing assistance to the Commission's staff with the review of HECO's initial annual decoupling tariff amendment filing, statement of position by the Consumer Advocate and determination of the reasonableness of the proposed decoupling rate adjustments.

Task 3: Process Evaluation and Recommendations for Improvements Task 3 included examination of the review process for HECO's initial decoupling filing and development of recommendations for possible improvements for future decoupling tariff filings.

All three tasks included meetings and deliberations with the Commission staff, the HECO Companies and the Consumer Advocate as well as assistance and written reports provided to the Commission.

Task 1 Summary: Preparation for Filing Review Process

The purpose of Task 1 of the decoupling review project was to prepare for the time-constrained review of the initial decoupling tariff filings. This task included prior review of the Decoupling Mechanism, examination of the key issues expected in the initial tariff filings and planning and establishing a review process.

The review process established in Task 1 included the following work plan:

Task 1: Preparation

- *Assembly of the Commission review team*
- *Initial check-in with the utility and the Consumer Advocate regarding the tariff filing and review process*
- *Examination of issues that can be identified prior to the tariff filing*
- *Discussion with Commission staff regarding expected tariff process, review process, pertinent issues, possible discrepancies and identifiable unresolved details*
- *Scheduling informal information conference ASAP after tariff filing*

Task 2: Review of the tariff filing:

- *Meet with HECO staff and the Consumer Advocate team at a prompt informal information conference with follow-up as necessary*
- *Identify ambiguities and missing information, follow up with informal and formal information requests as appropriate*
- *Determine whether revenues and authorized revenues are properly stated*
 - *Assess the appropriate scope and depth of auditing of information in the filing; follow up with information requests and analysis as appropriate.*
 - *Note: The initial filing in 2011 did not include an "evaluation period" to determine company rate of return on equity. It was therefore not necessary to carefully review actual company expenses. The initial review examined only actual versus authorized revenues. In*

subsequent reviews for each company it will also be necessary to review actual expenses in order to determine return on equity in the evaluation period as part of the review of the EPES mechanism.

- *Assess the nature and depth of the investigation by the Consumer Advocate review team*
- *Determine whether the tariff filings are consistent with the tariffs*
- *Determine whether the filings (and the tariffs as implemented) are consistent with the intended functions and objectives of the Decoupling Mechanism.*
- *Review the findings and recommendations in the Consumer Advocate's scheduled statement of position addressing the tariff filing*
- *Request modifications of the tariff filings as appropriate*
- *Review any stakeholder protests*
- *Determine whether the tariffs should be allowed to become effective or whether they should be suspended for further investigation or consideration*

Task 3: Determine Recommendations for Improvements

- *Evaluation of the tariff review process / identification of problems and inefficiencies*
- *Development of protocols for future tariff reviews*
- *Development of recommendations to improve the Decoupling Mechanism process generally.*

As part of Task 1, HDA prepared several drafts of a monthly timeline spreadsheet for the years 2009 through 2016 showing hypothetical dates and periods for decoupling tariff reviews, rate case test years, implementation of interim and final rates, RAM calculation periods, RAM accrual periods, RAM collection periods and earnings evaluation periods. The purpose of the timeline was both analytical (figuring out how things will work), exploratory (sharing with stakeholders for comment to explore consistency of understanding) and expository (explaining issues and potential problems or controversy).

Prior to the initial decoupling tariff filings on March 31, HDA was optimistic that the review process would proceed smoothly. HECO and the Consumer Advocate agreed to pursue timely informal discovery and participate in several meetings to present and discuss the tariff filings. HECO seemed motivated to ensure that the tariffs would be presented in a way that would allow them to go into effect without controversy or protest. The Consumer Advocate review team included the same consultants that participated in the recent decoupling docket that established the effective decoupling tariffs and who negotiated most of the terms of the tariffs with HECO.

One important issue was identified that was not explicitly resolved by the language in the Decoupling Mechanism tariffs or the Decoupling Final D&O: It was not explicitly determined how RAM accrual periods and RAM collection tariffs would initially be characterized and then be recalculated in years that interim and final rate case tariffs would take effect. HDA suggested informally to HECO and the Consumer Advocate that the tariff filing might include an exhibit that

would explain and include a sample demonstration of what would happen in these circumstances.

HDA also suggested that, in future rate case filings, the results of operations presented in the general rate cases could break down labor and non-labor components of operating expenses and clearly tabulate any other new distinctions necessary for the implementation of the RBA and RAM tariffs.

Several challenges were identified:

- The tariffs have several moving pieces, which creates some complexity.
- There would probably be voluminous documentation associated with the tariff filing.
- There is some uncertainty regarding the necessary depth of auditing.
- The mechanisms are a substantially new ratemaking approach.
- There are possible hidden surprises.
- There could possibly be stakeholder protest(s).

Task 2 Summary: Execution of Review of Initial Decoupling Tariff Filing

The work plan for the tariff review process included the following provisions for Task 2:

Task 2: Review of the tariff filing:

- *Meet with HECO staff and the Consumer Advocate team at a prompt informal information conference with follow-up as necessary*
- *Identify ambiguities and missing information, follow up with informal and formal information requests as appropriate*
- *Determine whether revenues and authorized revenues are properly stated*
 - *Assess the appropriate scope and depth of auditing of information in the filing; follow up with information requests and analysis as appropriate.*
 - *Assess the nature and depth of the investigation by the Consumer Advocate review team*
- *Determine whether the tariff filings are consistent with the tariffs*
- *Determine whether the filings (and the tariffs as implemented) are consistent with the intended functions and objectives of the Decoupling Mechanism.*
- *Review the findings and recommendations resulting from the Consumer Advocate's review of the tariff filing*
- *Request modifications of the tariff filings as appropriate*
- *Review any stakeholder protests*
- *Determine whether the tariffs should be allowed to become effective or whether they should be suspended for further investigation or consideration*

All of these components of the review process were, in fact, executed in Task 2 except that there were no stakeholder protests. In this sense the review process proceeded as planned. As explained below, however, the review process did not proceed in the straightforward manner optimistically predicted in the summary of Task 1 activities.

There were two contested issues that required resolution by the Commission. Several other issues were resolved by mutual agreement between HECO and the Consumer Advocate. These issues are identified and briefly discussed below.

A big surprise in the review of HECO's tariff filing was a major contested issue regarding a fundamental aspect of the Decoupling Mechanism. During Task 1 it was observed that the decoupling tariffs did not explicitly address what would happen to RBA revenue collections when the Commission issued an interim order in a general rate case. HDA suggested to HECO that this matter be specifically addressed in HECO's tariff filing so that the Commission and all parties would have a common understanding. HECO responded with its explanation in an "Attachment 5" to its March 31, 2011 tariff filing.

Prior to HECO's tariff filing, this matter was considered to be a detail that needed to be addressed. It was promptly discovered in reviewing HECO's Attachment 5, however, that resolving this detail revealed a major difference in understanding between HECO and the Consumer Advocate regarding the fundamental basis for applying the RAM tariff. The differences between HECO and the Consumer Advocate on this matter were extensive, including differences in the purpose and intent of the Decoupling Mechanism and how the mechanism should be implemented. The parties even disagreed regarding what matters were previously agreed in their joint filings with the Commission. The amount and timing of revenue recovery resulting from the different positions of the parties was substantial.

The differences in position on this matter came as a surprise to all of the stakeholders, especially in light of the fact that the Decoupling Mechanism adopted by the Commission was the direct result and work product of deliberations and joint filings by HECO and the Consumer Advocate in the decoupling docket. Several simultaneous written filings and responses were swiftly scheduled to resolve this matter and it was ultimately decided by Commission Order.

Aside from this substantial contested matter, all other issues were resolved by HECO and the Consumer Advocate without need for decision by the Commission. Ultimately, all details and differences were resolved, without official protest and without a contested case proceeding. HECO's decoupling tariff amendment was implemented on June 1, 2011 as originally scheduled.

Review Process Communications

The review of HECO's initial decoupling filings was conducted in accordance with the Commission's rules that govern public utility tariff filings (HAR 6-61-111 and 6-61-61) except as otherwise specifically provided in the Commission's Decoupling Final D&O. Accordingly, the process was not a contested case, was not docketed and there were no barriers on ex parte communications between the parties, HDA and the Commission staff.

There was a substantial amount of informal discussion and communication that proved essential in reviewing HECO's initial tariff filing and resolving details and some substantial

issues within the sixty-day timeframe provided in the Decoupling Final D&O. The forms of discussion and communication included:

- Scheduled Filings - The Commission's decoupling tariffs and directives in its Decoupling Final D&O provided for several scheduled steps in the annual Decoupling Mechanism implementation:
 - On or prior to March 31 each year, HECO (and each utility subject to the decoupling provisions) must file its decoupling tariff amendment request.
 - Within thirty days of the transmittal, the Consumer Advocate must file a statement of position on the tariff amendment request.
 - The tariff amendment request takes effect on June 1 unless the Commission suspends the tariff amendment on its own initiative or in response to a protest (which must be filed at least fourteen days prior to June 1). If suspended by the Commission, the tariff amendment request becomes a contested case and is docketed for further investigation.
- Additional Filings with the Commission
 - In order to resolve differences between HECO and the Consumer Advocate regarding the substantial issues raised in HECO's "Attachment 5", simultaneous Statements of Position and simultaneous Replies were filed with the Commission.
 - The Commission ordered HECO to file amendments to the tariff filing to comply with its orders.
- Meetings and teleconferences to explain and discuss issues - Several meetings and teleconferences were scheduled to discuss the tariff filings and supporting exhibits and to provide an opportunity for the Commission staff and the Consumer Advocate to ask questions and identify concerns.
- Unfiled communications and discussions - HECO and the Consumer Advocate worked extensively and cooperatively to identify and resolve issues. The Commission staff did not participate in most of these discussions. Several documents that were work products of these discussions were provided as a courtesy to HDA and the Commission staff but were not officially filed with the Commission.
- Internal Commission Discussions – There were several meetings and ongoing telephone communications between HDA and the Commission staff regarding all aspects of the review process.

It became apparent in this first review process that improvements to the Commission's publicly accessible Document Management System (DMS), which was designed and launched prior to HECO's first tariff filing, were necessary to provide the general public and any potentially interested stakeholders (other than HECO and the Consumer Advocate) better notice of the tariff filing and easier access to documents filed as a part of the tariff review process. Because the review process was not a docketed matter, but was styled as a tariff transmittal process, DMS did not have the design or capacity to permanently store and

post for public use, documents filed relative to HECO's March 31, 2011 tariff filing. To provide public access, the Commission instead began posting documents filed as a part of the tariff review process via a link on the home page of the Commission's web site. It is recognized by the Commission and all parties that timely public notice and availability of review process documents should be improved in future decoupling tariff filing reviews.

Contested Issues

Labor Productivity Adjustment

Task 2 effectively began several days earlier than expected and prior to HECO filing its March 31, 2011 decoupling tariff transmittal. Based on discussions between HECO and the Consumer Advocate regarding the anticipated transmittal, these parties jointly requested a discussion with the Commission to resolve a contested matter regarding application of a labor productivity factor specified in the RAM tariff.

The RAM tariff is an automatic rate adjustment mechanism that increases the target revenues collected by the RBA tariff based on annual calculation of several ratemaking components. The RAM tariff provides that the labor component of HECO's allowed expenses shall increase at the rate of increase of actual organized bargaining unit labor wages, reduced by a specified labor productivity factor.

In HECO's then-most-recent general rate case D&O (Final D&O in HECO's 2009 test year general rate case: Docket No. 2008-0083), the Commission dis-allowed certain components of labor expense increases. HECO argued that the labor productivity factor specified in the RAM tariff should not be applied to the specific labor expenses for which increases were dis-allowed. The Consumer Advocate argued that the productivity factor should be applied to all labor expenses without exception. The Commission held a conference call with the parties, where HECO and the Consumer Advocate explained their positions on this matter. During the conference call, HECO announced that it noticed just before the conference call that the version of the RAM tariff approved by the Commission as part of HECO's filing of results and operations pursuant to the Final rate case D&O specifically stated that the labor productivity would not apply to the dis-allowed labor increase component. The Consumer Advocate responded that it was not aware of this change in the language of the RAM tariff. The Consumer Advocate conceded that, for the immediate purposes of the imminent filing, the matter was therefore resolved in HECO's favor but reserved the right to argue the merits of the matter at a later date.

Retroactive Revenue Accrual Versus Regulatory Lag: "Attachment 5 Issues"

As part of the Task 1 activities, HDA developed a timeline spreadsheet for purposes of examining and explaining the timing of the implementation of the RBA and RAM tariffs. The spreadsheet showed the timing of the decoupling calculation periods, evaluation periods and rate implementation periods and the components of effective rates in context with the timing of general rate cases test years and rate adjustments resulting from interim and final orders. One issue that became clear from the preparation and examination of the timeline spreadsheets was substantial ambiguity regarding what should happen when the Commission would issue an interim decision in a rate case test year. When interim rates were implemented during a rate case test year, would recovery of RAM revenue adjustments cease, continue or be modified? Would a separate tariff adjustment be required or would any adjustments happen in the context of the implementation of interim

rates? This was not explicitly addressed in the Decoupling Final D&O or in the text of the RBA or RAM tariffs.

HDA discussed this matter informally with HECO and the Consumer Advocate and suggested (with the knowledge of but not officially on behalf of the Commission staff) that it would be helpful if HECO would address this matter explicitly in its March 31 tariff filing so that it would be clear to all parties what was expected. HECO's March 31, 2011 filing included a responsive detailed discussion and example in "Attachment 5".

It soon became clear that the Consumer Advocate did not agree with HECO's position expressed in Attachment 5. Furthermore, it became clear that this was not just a difference regarding a detail but a difference regarding a fundamental aspect of the purpose and implementation of the RBA and RAM tariffs. HECO and the Consumer Advocate had different conceptions of how, when and the extent to which revenues calculated according to the RAM tariffs would accrue as utility assets collectable from utility customers.

The RBA tariff provides a mechanism that ensures that HECO will recover its non-fuel, non-purchased power authorized target revenues regardless of sales volumes or other factors. Authorized target revenues are established initially in a general rate case. The RAM tariff provides for annual increases in authorized target revenues based on several provisions to adjust revenues for expense and capital recovery related components. The RBA target revenues are adjusted ordinarily starting June 1 of each year after a sixty day review period to evaluate the utility's March 31 decoupling tariff filing.

HECO believed that the RAM adjustments to revenues, calculated for the one-calendar-year, January 1 through December 31 RAM calculation period defined in the RAM tariff, were a determination of an amount of revenue to which the utility became entitled when approved on June 1 of each year. The RAM revenue adjustments would be collected through the RBA mechanism starting June 1 of each year through May 31 of the following year when the next RAM revenue adjustment would commence. There would be a five month lag in collection of revenues (January 1 to June 1) but HECO expected that it was entitled to all of the RAM calculation period revenues calculated starting on January 1 of each year (even though the revenue adjustments would not be approved until June of each year).

In a rate case test year, interim rates are implemented immediately after an interim order is issued, typically sometime near the middle of the calendar year, often around July. HECO's position was that, in a rate case test year, it would be entitled to collect RAM adjustments to its rates that would start accruing on January 1, and would continue to accrue adjusted revenues until the date that new interim rates would take effect. At the time new interim rates took effect, uncollected RAM adjustments would be calculated and a pro-rated adjustment would be made to fully compensate the utility for its accrued but uncollected RAM revenue adjustments.

The Consumer Advocate believed that the calendar year RAM period defined in the RAM tariff served as a test year to calculate the adjustment to authorized target revenues. The authorized target revenues would take effect in the RBA tariff starting June 1 of each year and would be in effect until changed, either by the following year's decoupling tariff adjustment in June or until superseded by new rates established by the Commission in an interim and/or final rate case order. The Consumer Advocate did not believe the tariffs

intended for there to be any retroactive accrual or entitlement to revenues. RAM revenue adjustments would simply accrue monthly to the utility starting in June of each year to the extent they are incorporated in RBA authorized target revenues.

In effect, HECO believed that the intent and function of the RAM and RBA tariffs was to eliminate regulatory lag (from an accrual standpoint) with a mechanism that provided for a five-month lag in recovery of revenues. The Consumer Advocate believed that the intent and function of the RAM and RBA tariffs was to reduce regulatory lag to approximately five months.

Both parties were motivated to resolve this matter quickly to allow for HECO's initial decoupling tariff adjustment to go into effect as scheduled on June 1, 2011. At an informal meeting held at the Commission on April 6, 2011, HECO explained its position on the Attachment 5 issues. HDA and the Commission staff asked several questions on this matter. The Consumer Advocate reserved comment. HECO and the Consumer Advocate requested and scheduled a subsequent telephone conference call with the Commission staff and HDA to discuss how to proceed. During the telephone conference the parties arranged for simultaneous filings of statements of positions on Attachment 5 on April 21, 2011 and simultaneous replies to be filed on April 29, 2011 concurrent with the Consumer Advocate's already scheduled comments on HECO's March 31, 2011 tariff filing.

HECO and the Consumer Advocate both filed substantial statements of position and replies as scheduled. The Commission and staff met on several occasions with HDA to discuss and deliberate on matters including the Attachment 5 issues. On May 20, 2011, the Commission issued an order deciding the Attachment 5 issues, essentially in favor of the Consumer Advocate's position, and requesting HECO to file amended tariff pages in accordance with the order.

Mutually Resolved Issues

Consumer Advocate Review

Several specific corrections and/or changes to the calculations of the rate base RAM component of HECO's tariff filing were recommended by the Consumer Advocate in its April 29, 2011 Statement of Position. Most of the Consumer Advocate's recommendations for changes were discussed with HECO prior to filing. With the significant exception of the "Attachment 5" issues, HECO agreed to all of the changes suggested by the Consumer Advocate. All of the changes pertained to specific line items:

- Slight adjustment to one line item amount of Amortization of Contributions In Aid of Construction
- Adjustment to several line item amounts of Accumulated Deferred Income Taxes (ADIT) to account for eligibility for Bonus Tax Depreciation, disallowed costs and one inadvertent omission.
- Corrections of ADIT amounts for excess CT-1 project costs
- Correction of eligibility for bonus depreciation for one capital project.

HDA and Commission Review

HECO provided supplemental information on an informal basis in response to questions and informal requests by HDA and the Commission staff.

Task 3 Summary: Process Evaluation and Recommendations for Improvements

The primary objective of Task 3 was to identify and make recommendations regarding outstanding issues and possible improvements to the decoupling tariff review and implementation process.

Task 3 included:

- Several meetings with PUC staff and HDA
- Informal requests for information from HECO
- Meeting with tariff review process stakeholders and PUC staff, including presentations by HECO regarding requested information
- Ongoing informal meetings between HECO and the Consumer Advocate
- Written summary and recommendations by HDA

HECO and the Consumer Advocate are continuing a series of meetings and deliberations to prepare for upcoming annual decoupling tariff filings. The Consumer Advocate, with HECO's cooperation and participation, is developing a spreadsheet template model that includes all of the calculations necessary for implementing the annual RBA, RAM and EPES mechanism adjustments. This process is serving as a venue for rigorous review of decoupling process calculations.

As part of Task 3, HDA provided a report to the Commission to serve as a basis for internal discussions regarding issues and possible improvements to the Decoupling Mechanism and process. Several issues and possible modifications were identified with recommendations regarding immediate steps to determine whether, when and how the Commission might take appropriate action. Topics addressed in HDA's report included:

- **CORRECTNESS** – Are the existing protocols for determining decoupling tariff adjustments correct and consistent with the Commission's directives?
 - Calculation and implementation of the RBA and RAM mechanisms
 - Calculation and implementation of HECO's ECAC deadband mechanism
 - Calculation and implementation of the EPES mechanism
- **FORM AND CONTENT OF ANNUAL DECOUPLING TARIFF FILINGS** – Can improvements be made to the form or content of the annual decoupling tariff filings to make the review process more straightforward and efficient?
 - Definition and annual approval of Authorized Base Revenue and RAM revenue adjustments
 - Advance documentation of necessary information (immediately after each rate case)
 - EPES mechanism calculation conventions

- Integrated RBA/RAM/EPES calculation model
- PROCESS FOR REVIEWING ANNUAL DECOUPLING TARIFF FILINGS – Should changes be made to any aspects of the procedures used to review and approve annual decoupling tariff amendments?
 - Governing procedures: existing tariff rules and protocols versus special provisions of the decoupling tariffs
 - Allowed scope of review for an “automatic adjustment clause”
 - Sufficiency of public notice and access to tariff documents
 - Public record of documents
- PERIODIC REPORTING OF DECOUPLING-RELATED INFORMATION – Do the annual, quarterly and monthly reports provide clear and sufficient information to document and monitor the implementation of the Decoupling Mechanism?
 - Implementation of RBA accounting and monthly reporting of RBA balances
 - Implementation and reporting of ECAC heat rate deadband calculations
 - Quarterly reporting of achieved ROE

HDA also recommended the following next steps to resolve the identified issues and determine what actions are appropriate prior to the next round of decoupling tariff filings.

SUGGESTED NEXT STEPS:

- Schedule a meeting with Commission staff and HDA
 - Discuss the issues and possible improvements identified in this report
 - Identify a general agenda and a list of topics and questions for a follow-up meeting with staff, HECO and the Consumer Advocate
- Provide a list of topics and questions for discussion to HECO and the Consumer Advocate and schedule a meeting
 - Objective: discuss whether, what and when the Commission should take any actions regarding decoupling prior to annual 2012 tariff filings
- Meet with Commission staff, HDA, HECO and the Consumer Advocate
- Schedule a follow-up Commission staff meeting to determine what actions, if any, are appropriate