Big Risks Led To Big Losses For Hawaiian Electric

Hawaiian Electric leaders tried to turn an electric utility into an investment powerhouse. It didn't quite stick.

JULY 25, 2016 · BY ERIC PAPE

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Transformation came to the Hawaiian Electric Co. in 1983.

And it came in the form of a Yale-educated, right-wing descendent of Calvinist missionaries whose vision for the 90-year-old company was forged from 27 years of studying HECO from the inside.

HECO President and CEO Dudley Pratt Jr. was a structural engineer with a master's degree in business administration. He joined the utility in 1953 and worked his way up through the ranks to become its head in 1981.

"Despite decades of stability, the future for Hawaiian Electric appeared to be one of slow growth, or no growth at all," Pratt would later say. "In my mind, it was an intolerable situation."

THE STORY SO FAR

Hawaiian Electric Co. was created in 1891 and has been entwined in Hawaii's economy and politics ever since. It obtained exclusive rights to provide power in Honolulu shortly after the Hawaiian Kingdom was overthrown and the federal government took over. The company grew rapidly as the state grew, helping steer the development of Oahu and pulling the state through economic hard times, two world wars and statehood. Its reliance on oil to power generators proved to be a real problem that persists today.

Simply relying on more customers and increasing sales just wasn't cutting it anymore. Diversification was the new buzzword.

Pratt relied on another timeless maxim — what he called capitalism's "remorseless rule."

"You either grow or die."

And Pratt wanted to grow big. In his vision, HECO would grow beyond electricity. It would grow beyond Hawaii.

Former Gov. John Waihee took office in 1986 and served eight years. A staunch Democrat, he developed a close relationship with Pratt despite what he calls their sharp political differences.

"His politics were maybe to the right of Attila the Hun, but he was a good friend," Waihee said recently. "We could talk about preserving Hawaii and what was special. Sometimes the politics could be far apart, but the sense of belonging and preservation was equal."

The New Hawaiian Electric

In 1983, Pratt presided over the creation of Hawaiian Electric Industries, which has grown into the largest company in the state. It was started as a holding company that folded the 92-year-old HECO in as its first subsidiary and had visions of expanding into many different commercial sectors.

The Hawaii Public Utilities Commission set numerous conditions on the transformation, including measures that would financially protect ratepayers if new business ventures failed. Among other things, the regulators prohibited HEI from loaning electric utility money to any non-regulated entity it might create or purchase.

The name of the new game was making money. The holding company began aggressively seeking out new investment opportunities.

In 1984, the holding company established HEI Investments Inc., which was created largely to invest in corporate securities and other long-term investments. Its cash began to flow far beyond the shores of an isolated archipelago in the middle of the Pacific Ocean.

At about the same time, other big Hawaii businesses were struggling to find success outside of Hawaii, where a very different and much more competitive business environment awaited them.

Dudley Pratt Jr., left, earned his MBA from the University of Hawaii. In 2010 he established a scholarship fund and sat for this photo with business school Dean V. Vance Roley.

David Heenan ran Theo H. Davies & Co. at the time. One of the iconic Big 5 Hawaii companies, the company was the first to get out of sugar and diversify its holdings, eventually owning Pizza Hut and Taco Bell franchises in Hawaii and car dealerships like Jaguar.

"It is hard to get beyond the rock," Heenan said in a recent interview.

In 1985, the HEI investment subsidiary put money into a coal-burning power plant in Georgia and pumped millions into a venture capital fund along with other utility holding companies.

Investors liked what the holding company was doing and HEI's stock shot up 34 percent.

Over a four-year period, the value of the stock doubled.

A wind farm operation. A North Shore real estate business. Investments in Arizona, New Mexico and elsewhere on the mainland.

In 1986, HEI invested in the interisland freight company, Young Brothers, and its sister company, Hawaiian Tug & Barge, which operated ocean-going as well as harbor tugs and barges. The revenues quickly proved better than expected.

Hawaiian Electric Industries bought Young Brothers and its tug and barge operation in 1986, then sold it for a loss in 1999.

In 1987, HEI Investments continued to diversify, spending another $50 million. Total non-electric company investments reached $179 million.

The holding company bought the Hawaiian Insurance Group for $41 million. In a speech to an educational foundation focused on business, Pratt lauded the insurance company's 55,000 policies. The utility company had grown into the fifth largest insurer in the islands.

Electricity Sales Continued To Rise

The power company itself was actually doing well, despite Pratt's fears that it would falter. HECO and its subsidiaries on Maui and the Big Island were benefitting from the new electronics of the era — early home computing, fax machines, CD and video players — along with effusive air conditioning systems.

On a hot September day in 1987 peak demand for electricity exceeded 1 million kilowatts for the first time in Hawaiian Electric's history — and the lights stayed on.

American Savings has been a reliably profitable investment for HEI since 1988.

And the flurry of investments was far from finished. In 1988, HEI purchased American Savings Bank's branches in Hawaii for $113 million.

HEI had not planned to focus on financial services, but it couldn't resist the chance to buy them from the American Savings and Loan Association in Salt Lake City, Utah. American Savings had gotten caught up in the $150 billion savings and loan crisis of the mid-1980s when risky investments led to the collapse of more than 1,000 thrifts nationwide and ensnared U.S. senators in schemes to help financiers like Charles Keating Jr.

To fund that purchase, HEI reached out to mainland and international investors. The company sold 2.5 million new holding company shares in the U.S., Europe and Japan, bringing in $77.2 million through the stock offering.

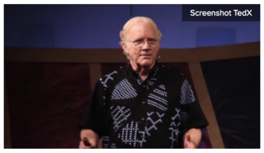
Robert Clarke, who took over the leadership of HEI when Pratt retired in 1990, says now that it quickly became apparent that the purchase of the reliably profitable bank was "a home run for us."

But HECO's traditional customers weren't so sure they liked their utility's parent company being involved in such a disparate array of businesses.

"From the public standpoint, it was: How do these work together?" recalls Robbie Alm who at the time was the director of the Hawaii Department of Commerce and Consumer Affairs, which played a role in regulating the electric utility.

Alm, who later became one of HECO's top executives, says there were similar internal problems with company employees feeling that greater importance was being given to larger, diversified investments than to Hawaiian Electric's traditional business.

Clarke says that the utility wasn't at all harmed by the activities of the bigger HEI "but some people might have felt that way."



Robbie Alm moved from overseeing the Hawaiian Electric Co. as a state official to one of the company's top executives.

"It is like a first child," he says, "when the next child in the family is born, they say: 'What about me?'"

In 1988, Pratt dismissed the criticism in a speech to shareholders. Some people seemed to believe, he said, "we were getting too big, that HEI was on an ego trip."

The demand for electricity continued to grow — by 5.6 percent in 1988 — and HECO began to turn to independent power producers to help bolster its own generation capabilities.

The time had come for HECO to upgrade and strengthen its power production and distribution system. Some facilities had been in place since before World War II and were more than 50 years old.

In 1992, HECO decided to spend $1 billion over the next five years to revamp the system.

But that plan changed on Sept. 11, 1992.

The eye of Hurricane Iniki slammed into Kauai and hovered over the island for 40 minutes. Winds reached 160 miles per hour and, along with wave surges, knocked down power lines and damaged 14,000 homes on Kauai and Oahu. More than 1,400 homes were destroyed.

This time, the hurricane wasn't just a problem for a utility company struggling to repair downed lines and get the power back on.

By early December, more than $300 million in claims had been filed with the Hawaiian Insurance Group, the company Hawaiian Electric Industries had purchased five years earlier.

"We put some money in from the holding company until we realized that the overall losses (from the storm) were over $2 billion," recalls Clarke, the former HEI president. "Those losses were way more than we could handle."

It suddenly became clear that gambling against a big disaster in a place prone to disasters was bad business for HEI. The holding company abandoned its insurance subsidiary, letting it fall into what became one of the largest bankruptcies in Hawaii history with a spate of legal battles to come.

Hurricane Iniki hit Kauai and Oahu hard in 1992. It also bankrupted Hawaiian Insurance Group, a subsidiary of HEI.

Clarke says now that it was shortsighted to invest in an insurance company that was in no position to handle a high-cost "once-in-a-century storm" like Hurricane Iniki. That would have been more suitable for a national company that could spread its risks across many states, he added.

By the end of the year, HEI's stock was down 10 percent. And HECO's plans for $1 billion in capital improvements fizzled after the insurance company went bankrupt.

Still, the storm and its fallout did little to dampen the company's enthusiasm for investment far beyond Hawaii.

Diversification Continues Far From Home

In 1995, the holding company created a new electricity services subsidiary called HEI Power Corp. It sought out lucrative deals in faraway locations like Guam, the Philippines and even a remote region in China.

The utility had much experience operating standalone grids — distribution systems that didn't rely on sharing power with other electric grids operated by different companies in neighboring states, for instance. HECO had been operating a standalone grid for 100 years and had learned much about how to make electricity distribution as effective and reliable as possible.

Robert Clarke led HEI for 15 years until he retired in 2006.

"The theory was that a lot of places in the world, particularly in Asia, operate standalone grids," said Clarke. "We have an ability to operate those sorts of grids."

The company also believed that the ethnic makeup of Hawaiian Electric's diverse work force might play well in parts of isolated Asia.

In 1996, the Guam Power Authority hired HEI Power to refurbish a plant. Clarke filed a statement with the Securities and Exchange Commission saying that Hawaii's electric utilities would have no direct relationship with or own any interest in the venture in Guam.

That project went well and HEI stepped up its efforts to find more business outside Hawaii.

The holding company moved into more distant and far riskier terrain.

The city of Baotou in the Inner Mongolia region of northern China was about as far off the grid as Clarke and other HEI executives might have imagined before they entered into a partnership in 1998 with Baotou Iron and Steel, a huge state-owned Chinese metal works company.

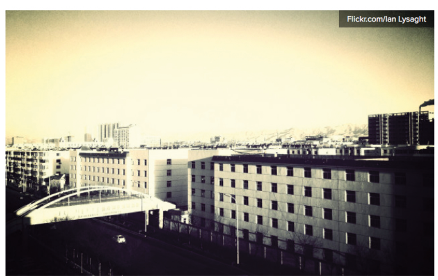
HEI Power obtained a 75-percent stake in a joint venture, the Baotou Tianjiao Power Co., and signed on to design, build, own and manage a coal-fired power plant on the edge of the Gobi Desert for the metal-works company.

To advance, the joint venture needed government approval as well as an interconnection deal with the local utility, Inner Mongolia Power, which already had wires running to a steel and iron mill that needed power.

Chinese authorities and local regulators issued all the permits needed and HEI began to spend some of the $110 million it planned to invest in the project.

But then, Clarke said, Inner Mongolia Power lost a major electric customer so the local Chinese utility suddenly had more than enough energy to supply the metal-works company itself.

Despite what it thought were firm contracts, HEI Power could never get the crucial connection agreement it needed to make the project a go. There was no legal means to force the commitments the company thought it had obtained.



Hawaiian Electric Industries lost nearly $20 million on a failed project to build a coal-fired power plant near Baotou, a city in Inner Mongolia in northern China.

"In China, they don't have the rule of law that we do," he said. "The courts report to the government and the Communist Party, so once the government makes a decision to not follow through on a project, there isn't much you can do."

In 2000, HEI announced it was bailing out. "I stopped the project," Clarke said, "and we lost $20 million."

Later, HEI recouped a few million dollars from arbitration with the Chinese company, but in the short term, HEI shares took a pounding, losing almost 4 percent of their value.

The loss of the Chinese project came on the heels of another failed venture.

The year before, HEI had decided to sell Young Brothers and Hawaiian Tug & Barge to a Washington state company, Saltchuk. Clarke said HEI was wary of suffering the same kind of marine liability and litigation problems that were continuing to plague Exxon even 10 years after the 1989 Exxon Valdez oil spill in Alaska. The two companies made up a small part of HEI's portfolio, but suddenly the risk seemed out-sized, recalls Clarke.

Hawaiian Electric Industries estimated its after-tax loss would be about $2 million. But in 2000, as Clarke was deciding to bail on the Inner Mongolia project, the holding company's annual earnings cascaded from $92.9 million in 1999 to $45.7 million.

The Philippines Folly

And yet, HEI Power didn't give up on its overseas dreams.

In 2000, the company bought a 46 percent stake in a company that owned five power plants in the Philippine metropolises of Cebu City and Manila. That seemed promising enough for the company to invest $87 million, albeit in the local currency, the Philippines peso.

But once again events well beyond HEI Power's control led to trouble — and substantial losses.

In October 2000, Philippines President Joseph Estrada, a popular film actor-turned-politician, was accused of taking a sizable payoff from a gambling operation as well as skimming from a government-subsidized tobacco marketing cooperative. Impeachment proceedings were brought against him. He was later ousted in a coup and eventually went to jail. Thanks to wide media coverage, it was the first time the Filipino public had witnessed the impeachment and trial of a president.

The political turmoil drove the peso through the floor, rapidly deflating the value of HEI's investment there.

The holding company lost $100 million on that deal and Clarke now says HEI should have fully hedged its investment against the possibility of a massive currency shift.

But Clarke made sure he "never bet the whole company" on any of the overseas investments, whether it was Inner Mongolia or the Philippines.

The massive Anahola solar farm on Kauai helped to place the Kauai Island Utility Cooperative at the forefront of renewable energy development in the islands. The co-op offers an alternative to Hawaiian Electric's privately owned business model in the islands.

Still, there was a growing sense at Hawaiian Electric that the corporation needed to refocus on its core business.

After that, he said, "I don't think there was much of an appetite for looking for other investments."

But when HEI decided to come home and refocus on its homegrown electric business, at least one major opportunity passed it by.

In 2002, Kauai Electric, the only non-HECO electric utility left in Hawaii, was up for sale. A customer-owned investor group offered $215 million in a play for the utility. HEI's bid fell about $15 million short of that, according to a lawyer for the winning bidder, and Kauai's power company became the Kauai Island Utility Cooperative.

In recent years, KIUC has been a leader in renewable energy and conservation measures with a large solar farm and smart meters in many homes and business.

In 2002, when HECO failed to lock up the last electric utility in the islands, it couldn't have anticipated that it, too, would be forced to embrace an alternative energy future, especially through an initiative coming from an unlikely political corner.

Next: Renewable energy finally becomes a serious prospect in Hawaii.

About the Author

CIVIL BEAT STAFF

Eric Pape

Eric Pape is the special projects and innovations editor for Civil Beat. He's written extensively for Newsweek magazine, the Los Angeles Times, Foreign Policy and Spin magazine. He has also contributed to The New York Times, The Guardian, Mother Jones, Salon, Slate and Vibe magazine. You can reach him by email at epape@civilbeat.com or follow him on Twitter at @ericpape.

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