

Hawaiian Electric Industries, Inc. NYSE:HE

FQ2 2022 Earnings Call Transcripts

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S&P Global Market Intelligence Estimates

	-FQ2 2022-			-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.52	0.48	▼ (7.69 %)	0.58	2.12	NA
Revenue (mm)	672.33	895.61	▲ 33.21	699.96	3104.00	NA

Currency: USD

Consensus as of Aug-09-2022 11:58 AM GMT

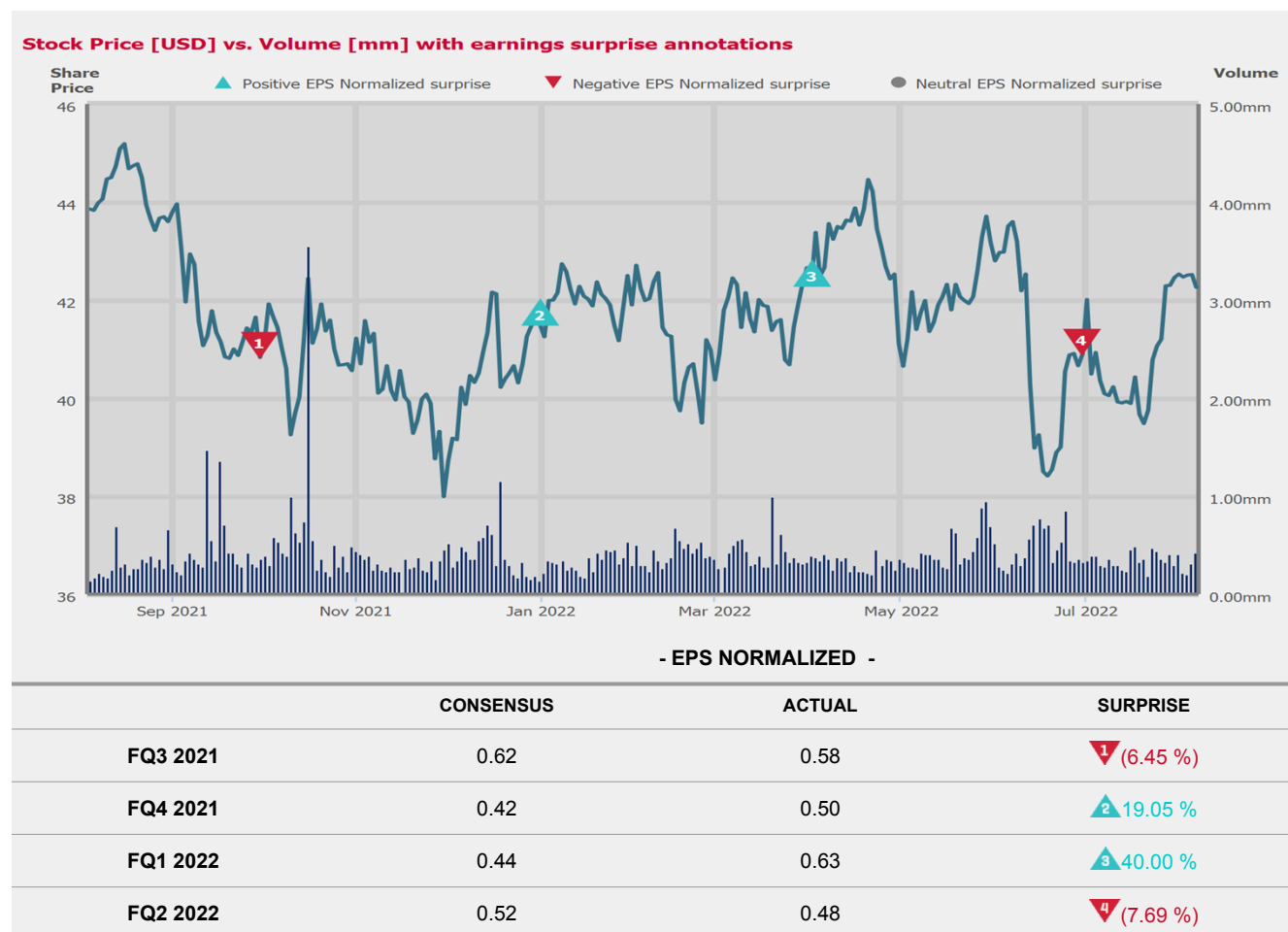


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Call Participants

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Julie R. Smolinski

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Senior VP, CFO & Treasurer of Hawaiian Electric Company Inc.

ANALYSTS

Julien Patrick Dumoulin-Smith

BofA Securities, Research Division

Paul Patterson

Glenrock Associates LLC

Presentation

Operator

Good afternoon. Thank you for attending today's Q2 2022 Hawaiian Electric Industries, Inc. Earnings Conference Call. My name is Tenia, and I will be your moderator for today. [Operator Instructions]

It is now my pleasure to pass the conference over to our host, Julie Smolinski, Vice President, Investor Relations and Corporate Sustainability. Please proceed.

Julie R. Smolinski

Vice President of Investor Relations & Corporate Sustainability

Thank you, Tenia. Welcome, everyone, to HEI's Second Quarter 2022 Earnings Call. Joining me today are Scott Seu, HEI President and CEO; Paul Ito, Interim HEI CFO; Shelee Kimura, Hawaiian Electric President and CEO; Ann Teranishi, American Savings Bank President and CEO; and other members of senior management.

Our press release and our presentation for this call are available in the Investor Relations section of our website. As a reminder, forward-looking statements will be made on today's call. Factors that could cause actual results to differ materially from expectations can be found in our presentation, our SEC filings and in the Investor Relations section of our website.

Now Scott will begin with his remarks.

Scott W. H. Seu

President, CEO & Director

[Foreign Language] Greetings, everyone. Thank you for joining us today.

We're pleased with our consolidated second quarter earnings of \$52.5 million and earnings per share of \$0.48. Our earnings reflect solid results at the Utility which continues to perform well under the performance-based regulation framework. While we've continued to see the higher O&M expenses we mentioned on last quarter's call and which we'll discuss further shortly. We expect to remain within our Utility guidance range for the year, albeit within the lower half of the range.

The Bank had a good quarter as well, benefiting from strong loan growth and the higher rate environment. With the bank's loan growth, the quarter also saw a return to a more normalized provision expense following 5 consecutive quarters of negative provision. While this reduced the Bank's results versus the prior year and linked quarters. This was consistent with dynamics anticipated for this year. Overall, we are reaffirming our consolidated guidance range for the year.

Taking a closer look at recent utility developments. Together with government agencies, regulators, developers and other stakeholders, we're making great strides in our clean energy transition. We're approaching a major milestone, the end of coal in Hawaii, a key action in our climate change action plan.

The retirement of the state's last coal plant is on track for September 1. The state's largest solar-plus-storage project came online July 31. Two more solar plus storage projects are slated to come online in the next few months, and the commission recently approved the last Stage 2 solar-plus-storage PPA that was awaiting decision.

The commission also asked us to consider adding solar to our proposed battery storage project on Maui, and we're working on a proposal to do so. In addition, the commission indicated it may reconsider our proposed Hawaii Island battery storage project that had previously denied after we learn whether we secured Infrastructure Investment and Jobs Act or IIJA funding for that project.

Renewable capacity approved by the PUC under Stage 1 and 2 RFPs that remain active totals nearly 575 megawatts with 2,250 megawatt hours of battery energy storage. We are continuing to seek more clean energy resources issuing our draft Stage 3 RFPs for Oahu, Hawaii Island and Maui, totaling 1,600 gigawatt hours annually of variable renewable dispatchable energy and between 540 and 740 megawatts of renewable firm capacity. We are working to grow customer resources as well.

Our expanded smart meter deployment continues with smart meters now in place for more than 20% of customers, and we now have greater flexibility under our recent commission decision to manage costs within the cost recovery mechanism for that program, as well as seek recovery of additional O&M associated with the increased deployment.

Finally, our state's RPS law has been updated and is now based on renewable generation as a percent of total generation rather than a percent of sales, consistent with our RPS-A Performance Incentive Mechanism or PIM. The effect of this formula change is that actual results will be lower while the RPS targets remain unchanged. However, all of our plans are designed to exceed the RPS-A targets, so we remain confident we'll meet our RPS goals. Ensuring reliability and resilience for our customers throughout this transition is a key priority.

We've purposely accelerated overhauls and maintenance on our generating units to meet electricity needs and enhance reliability as the coal plant approaches retirement. This, along with inflation, has impacted our O&M in the past 2 quarters, and we expect similar dynamics for the rest of the year. Strengthening our resilience to the impacts of climate change is also critical. Last month, we filed a 5-year plan with the commission that, if approved, will allow us to harden our grids while limiting customer bill impact to less than \$1 a month.

Last month, the commission issued an order in the performance-based regulation, or PBR docket, creating 3 new performance incentives covering generation reliability, cost management and timely completion of interconnection studies and extending the time frame for the grid services incentive. We propose that the new PIMs be effective January 1, 2023, and our request is pending PUC approval. The outcome reflects the collaborative efforts of the PBR Working Group, which the commission has designated as a forum for refining and developing further proposed performance incentives going forward. We know our customers are feeling financially challenged as inflation and high fuel costs continue to pressure household expenses.

Due to current high oil costs, we also expect a temporary increase in customer rates when the AES coal plant retires. We have comprehensive efforts underway to help customers manage their utility bills. This includes offering flexible payment plans, connecting customers to government and non-profit utility assistance programs, encouraging electricity conservation, energy efficiency and participation in our DER programs, transitioning away from fossil fuel generation to utility scale fixed rate solar and storage and continuing to look for ways to improve our cost structure such as through a cost-saving employee retirement program redesign we recently implemented.

Turning to the Bank. ASB continues to perform very well and maintains its high-quality position, including its low-risk profile, solid credit quality and low-cost funding base. The Bank's results for the second quarter are consistent with dynamics we anticipated this year.

Loan growth was strong during the quarter across most of the Bank's portfolio. We did see a return to more normalized provision expense to accommodate that growth, reducing Bank earnings compared to the prior year and linked quarters. We continue to see healthy activity in our loan pipeline. The rising rate environment drove margin expense in the second quarter and the Federal Reserve's additional rate increase last month is expected to spur further expansion -- I'm sorry, the rising rate environment drove margin expansion in the second quarter, and the Federal Reserve's additional rate increase last month is expected to spur further expansion.

Our Bank's digital transformation remains on track. We recently upgraded to Zelle for person-to-person payments and continue to invest in our digital transformation, including in customer relationship capabilities and data management.

Now I'll hand the call over to Paul, who is serving as our interim CFO until we complete our process to fill the CFO position.

Paul K. Ito

VP of Tax, Controller, Treasurer & Interim CFO

Thank you, Scott. Hawaii's economy remains healthy, and we believe it is well positioned to weather some of the economic headwinds we are seeing. Tourism arrivals have continued to strengthen. And in June, we're close to 90% of pre-pandemic levels.

Total domestic passenger counts year-to-date through July 2022 were very strong, over 11% higher than the total domestic passenger accounts year-to-date through July 2019. International arrivals, which traditionally account for over 1/4 of our total are still well below 2019 levels.

International tourism is picking up, however, and will serve as an additional tailwind for our economy. Japan is a key source of tourism for us, and in June, we saw the highest level of Japan arrivals since April 2020.

Arrivals from Canada are now approaching pre-pandemic levels and arrivals from other international markets are also higher than last year, although still well off of pre-pandemic levels.

Visitors are also spending more with June visitor expenditures 12% above 2019 levels. Hawaii's housing market has historically been strong compared to the mainland, and we've seen particular strength this year with housing prices hitting records in multiple months and inventory remaining tight.

Our housing market has performed well on a relative basis through downturns. From 2008 through 2011, the decline in single-family home prices in Hawaii was less than half the mainland average. This housing market stability, which is the result of limited supply and attractive location contributes to our bank's strong credit quality as 85% of the Bank's portfolio is real estate secured at conservative loan-to-value levels with a weighted average loan to value on a residential portfolio of less than 50% and on our commercial portfolio of less than 58%. Hawaii unemployment has also fared comparatively well during downturns.

During the great financial crisis, Hawaii's unemployment rate peaked at 7%, while national unemployment reached 10%. Hawaii's unemployment has trended favorably since its pandemic peak of 24% in April 2020 and was 4.3% in June, down from 5.9% in June of last year.

In summary, while there is measured optimism for the near-term path of the Hawaii economy, we continue to watch inflation and supply chain dynamics as well as the risk and possible impacts of a recession very closely. However, on a relative basis, the Hawaii economy has fared well through downturns in the past and is currently stable.

Turning to Slide 6. Our second quarter results reflected solid execution across the enterprise. The Utility continues to perform well in its first full year under PBR, and earnings were up 5% versus last year. We are seeing some pressures on Utility O&M, which I'll discuss shortly. The Bank saw strong loan growth and expanding net interest margin, although earnings were impacted by a more normalized provision expense given the quarter's strong loan growth.

Consolidated last 12 months return on equity remained healthy at 10.4%. Utility ROE was in line with expectations at 8.2% despite O&M pressures and Bank ROE remained strong at 13% on a last 12 months basis.

On Slide 7, we show the major variances across our enterprise compared to the second quarter of last year. Lower bank net income was primarily driven by a return to a more normalized provision expense \$2.8 million this quarter compared to the negative provision of \$12.2 million recorded in the second quarter of 2021.

Recall that we anticipated lower bank earnings compared to 2021 as we had sizable provision releases last year coming off large provisions taken in 2020 due to the pandemic. The Bank saw strong loan growth in the quarter. And although we did have some provision releases due to favorable credit trends, the releases were more than offset by provision expense, primarily driven by loan growth. Net interest income of \$61.8 million was up \$1 million versus the second quarter of last year due primarily to higher average earning asset balances partially offset by expected lower fee income associated with the Paycheck Protection Program, or PPP, as PPP loans continue to pay down.

Non-interest income was down compared to last year, primarily due to lower bank-owned life insurance income and lower mortgage banking income as the higher interest rate environment has impacted mortgage production. The Bank saw slightly higher non-interest expenses and like most companies, the bank has seen upward pressure on compensation and benefit costs due to the tight labor market.

Compensation and benefit expenses were also impacted by higher performance incentives from strong loan growth. Overall, the Bank continues to manage expenses well as it invests in its digital transformation.

On the Utility side, the 5% higher net income was primarily driven by higher annual revenue adjustment or ARA revenues and higher major project interim recovery revenues from grid modernization. These items were partially offset by higher O&M expenses, which were primarily driven by more generating facility overhauls and maintenance performed as well as higher bad debt expense. If you recall from last quarter, we messaged the continuation of higher generating facility maintenance throughout this year, which is driven by our efforts to maintain reliability as we approach the AES coal plant retirement and by increased maintenance needs as we cycle our older generating fleet more often to accommodate intermittent renewable energy.

To ensure adequate reserve margins, we needed to accelerate and complete our generating unit overhaul work in shorter periods of time, driving up costs. In addition, inflationary cost pressures have also impacted O&M. Bad debt expense has also been higher than anticipated given high fuel oil prices, leading to higher customer builds. Last year's deferral of COVID-related bad debt expense magnifies the year-over-year variance.

Turning to Slide 8. Utility CapEx through the second quarter was approximately \$125 million. This year's CapEx has been lower than anticipated due to headwinds from continuing supply chain disruptions permitting delays and resource availability constraints. We now anticipate that CapEx will be at the lower end of our \$350 million to \$400 million range for the year.

Turning to drivers for the rest of the year for the utility. As I mentioned earlier, we expect continued O&M pressures from higher generating station overhaul and maintenance expenses to maintain reliability as we transition off coal and cycle our generators more often. In addition, we are experiencing inflationary pressures on costs that exceeded the 2.8% inflationary allowance provided under PBR for 2022. Inflationary adjustment for 2023 will be determined by the forecasted 2023 GDPPI in October of this year.

We also expect bad debt expense pressures resulting from higher fuel oil prices and higher customer accounts receivable to persist through the year. Although we previously expected O&M for the year to be within the ARA allowance, we now expect it to be modestly above that level.

We are also now forecasting a net penalty this year from performance incentive mechanisms due mostly to the fuel cost risk sharing mechanism for which we expect to incur the maximum penalty given high fuel costs. We previously expected that better heat rate performance would substantially offset that, but heat rate performance have moderated since last quarter. We also expect that rewards from our interconnection PIM will be slightly lower than previously forecasted.

Turning to the Bank. ASB's net interest income growth in the quarter continued to reflect growth in earning assets and higher yields, particularly in the commercial and commercial real estate loan portfolios. We've also been able to maintain a low cost of funds at 5 basis points flat versus Q1. The low cost of funds has been a durable advantage for ASB even in rising rate environments. Net interest margin expanded to 2.85% versus 2.79% last quarter as the benefits of a higher rate environment and higher yields were only partially offset by lower PPP fees. We've now recognized nearly all remaining PPP fees with about \$300,000 left.

Turning to drivers of Bank performance for the rest of the year on Slide 11. The market now expects the Fed funds rate to be around 3.5% to 4% by year-end. We expect to continue seeing net interest margin benefits from the higher rate environment. Although on a comparative basis, quarter-over-quarter, we will see some offset from lower PPP fees. We now expect net interest margin for the year to be near the high end of our 2.7% to 2.85% guidance range.

We expect to continue seeing lower mortgage banking income this year given lower mortgage production due to higher interest rates. We anticipate some continued pressure on noninterest expense as we balance cost management with inflationary and labor market conditions as well as costs related to our digital transformation. We continue to see a healthy pipeline across the loan portfolio and expect to continue to redeploy runoff from the investment portfolio to fund loan growth.

Now turning to our guidance updates. On the utility slide, as mentioned, we are expecting CapEx at the lower end of our \$350 million to \$400 million guidance range. We are also expecting that PIMs will be a moderate drag this year based on the factors noted earlier. We also expect utility O&M to be modestly above ARA-allowed levels with continued pressure this year from higher generating station overhaul and maintenance expenses, higher bad debt expense and inflationary pressures. Overall, we expect utility EPS to be at the lower end of our \$1.68 to \$1.78 guidance range. On a longer-term basis, we still expect 2022 to 2024 earnings growth of approximately 5% with upside from PIMs.

Turning to the Bank. As mentioned, we are expecting NIM at the higher end of our guidance range. Given the inflationary environment and pressures on compensation and benefit expenses, we now expect non-interest expense to be slightly above the prior year. We are reaffirming bank EPS guidance in the \$0.59 to \$0.68 range, potential to be in the upper half of that range. We are still expecting a holding company loss of \$0.28 to \$0.30 for the year, excluding the \$0.06 gain on sale at Pacific Current in the first quarter. Overall, at this time, we are reaffirming our consolidated guidance range for the year of \$2 to \$2.20.

Now I'll turn the call back to Scott.

Scott W. H. Seu

President, CEO & Director

[Foreign Language] everyone, for joining us. We look forward to your questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from Julien Dumoulin-Smith with Bank of America.

Julien Patrick Dumoulin-Smith
BofA Securities, Research Division

Maybe just to kick us off here, you said a moment ago to quote you, right, you expect utility earnings to be at the lower end of the range with upside from PIMs. Can you discuss the PIMs upside potential here just considering the commentary from earlier in the remarks, with respect to the fuel cost and how those potentially impact your PIMs expectations along with the rewards from interconnect? I just want to understand exactly what's reflected in guidance and how that upside from PIMs could materialize at this point if you can speak to it a little bit, if you will -- the puts and takes.

Scott W. H. Seu
President, CEO & Director

Yes, I'll start off, and then I'll pitch it over to Shelee and team at the Utility. But that statement, as you recall, where we're referencing the '22 through '24 earnings growth. And whereas we are definitely seeing some PIMs headwinds this year, we are still looking at a potentially robust RPS-A PIM in the years '23 and '24.

And then as far as the fuel cost sharing, PIM, yes, we are, in particular, being challenged this year because of the high fuel oil prices. But like everybody, we are expecting that to moderate as we go forward. But let me ask Shelee and team if they want to add on to that.

Shelee M. T. Kimura
President, CEO & Director

Yes. You got that right, Scott. Julien, this is Shelee Kimura from Hawaiian Electric. So -- sorry, just taking off my mask here, still in this COVID world. So the comment on the upside for PIMs really is talking about the longer-term outlook. As Scott indicated, for 2022, we're really not expecting to be able to hit the PIM for RPS-A and that's where we get the greatest potential. But going forward, and this is because of all of the delays we've had because of supply chain and tariff impacts, all the things that you probably know about very well. We had to push back the in-service dates for many of our renewable projects. So that's also pushing back our RPS-A earning potential, and that's where we see the upside going forward.

Julien Patrick Dumoulin-Smith
BofA Securities, Research Division

Got it. And could you guys remind us just how that resets here with respect to the fuel year-over-year beyond '22 into the '23, '24 period?

Scott W. H. Seu
President, CEO & Director

Shelee? Team?

Shelee M. T. Kimura
President, CEO & Director

Yes. Can you just clarify your question when you said fuel?

Julien Patrick Dumoulin-Smith
BofA Securities, Research Division

Just how should we think about the elevated fuel cost cascading into '23, '24, again, net of these other factors that you just described, if we can try to quantify that a little bit more. Obviously, it's been a headwind this year, but how do you think about it in the next year, even if it's moderating, if you will?

Shelee M. T. Kimura

President, CEO & Director

Yes. Well, several factors, fuel is going to be somewhat unpredictable. We're expecting the impact for our customers to be up right now. But we do -- we are hopeful that it's going to come down in 2023. But of course, nobody has that crystal ball.

The other thing is that our fuel levels will get reset, and that is in January, and then I'll ask Tayne to add to that.

Tayne S. Y. Sekimura

Senior VP, CFO & Treasurer of Hawaiian Electric Company Inc.

This is Tayne. Just a quick summary of how the fuel cost risk-sharing mechanism works. In each January, a base index price is set for that fuel cost sharing mechanism. And depending on where prices go during the year, up or down, it determines how much we would have in terms of a penalty or reward. So really, the prices are going to be set in 2023 -- January 2023 will be the base index. Does that make -- does that make sense at all?

Julien Patrick Dumoulin-Smith

BofA Securities, Research Division

Yes, absolutely, right. What is a decrement this year could contribute to upside in subsequent periods, especially considering the reset period with the order here for the tens period '23, which is -- in some respects, what I was trying to get at earlier about what the puts and takes here in future periods as well, right? The extent of moderation could be a positive contributor next year?

Scott W. H. Seu

President, CEO & Director

Yes. And Julien one more thing -- sorry one more thing to add was that -- so essentially, as Tayne was describing, in January -- is when it will be reset, right, in terms of the fuel price index. And then as we would expect to see if fuel prices are able to decline as we get into 2023, then that actually is a benefit for us. So it has gone depending on the year and depending on what the January fuel prices are, that's going to determine whether or not that's a positive upside for us or negative.

Julien Patrick Dumoulin-Smith

BofA Securities, Research Division

Right. And maybe sort of to bring it in together super quickly here. As you think about that '24 period, you've got a 5% number out there in terms of growth. What is the hypothetical upside from PIMs considering this new order and just the outlook today, if I could tie it all together here?

Tayne S. Y. Sekimura

Senior VP, CFO & Treasurer of Hawaiian Electric Company Inc.

Julien, this is Tayne. Yes, I'll take that question. We do have some guidance on the RPS-A PIMs in the materials that, that provides the biggest opportunity there. So you can see the ranges we have for 2023 between \$2 million and \$6 million and then in 2024, between \$5.2 million and \$8 million.

But in addition to that, we also have a summary of our PIMs. And there are PIMs such as the grid services PIM, the interconnection PIM, which all provide some upside there. And the other thing that we also didn't talk about here is there are some new PIMs that potentially could be effective in 2023, awaiting a PUC decision on the effective date of those new PIMs. But there are some upsides there for the collective shared savings mechanism as an example.

Julien Patrick Dumoulin-Smith

BofA Securities, Research Division

Right. Numerous pieces moving here. I appreciate you guys walking through this. I know there are a lot of pieces.

Operator

Our next question comes from Paul Patterson with Glenrock Associates.

Paul Patterson

Glenrock Associates LLC

Okay. So I apologize if I missed this, but the Inflation Reduction Act, could you guys -- and I apologize I didn't hear much about it, I'm afraid. What do you guys think about it, generally speaking?

Scott W. H. Seu
President, CEO & Director

Yes. So generally speaking, and I'm sure you're hearing from other utilities along the same lines. We see a lot of potential upside, especially with respect to the tax credit provisions very supportive of our renewable energy strategies and projects. And ultimately, that will benefit our customers as well. So good legislation. The additional tax provisions actually do not look like they would impact us just because we would fall below the threshold. But overall, it looks like a positive piece of legislation. But let me ask if Paul or anybody else wants to provide some additional color.

Paul K. Ito
VP of Tax, Controller, Treasurer & Interim CFO

Yes, this is Paul. So yes, as Scott mentioned, we're very pleased by the progress that is being made to tackle climate change with the Senate approval yesterday. Obviously, we're still evaluating the bill. We're not at the finish line yet. But as Scott mentioned, we're very pleased with the clean energy incentives that will further incentivize Hawaii's transition to 100% renewable, which will, again, as Scott mentioned, lower cost for our customers, but also accelerate the Utility's progress in achieving its aggressive climate action plan.

The one provision, as Scott mentioned, that a lot of utilities are -- we're focused on outside of the incentives, of course, was this minimum tax. And because we're well below the threshold, we won't be affected by it. But there are a lot of provisions on the tax credit side that we're hoping that will benefit the broader community, but also the low to moderate income segment of our population. So obviously, there's a lot there for us to go through, but we feel very good about this new bill.

Shelee M. T. Kimura
President, CEO & Director

This is Shelee Kimura. I was just going to add that, as you heard, we have hundreds of megawatts that we're seeking and RFPs that are coming up. of renewable energy. And so this will really help lower cost for our customers as we go through this procurement process. And that's what we're hopeful for. It really depends on the timing of when that comes in and the timing of our RFPs and the bids that come through.

Paul Patterson
Glenrock Associates LLC

Okay. Great. There was -- one of the PIMs that you mentioned when the newer PIMs is this generation reliability one. Is that only for company-owned generation, I would assume? Or does that also involve of PPAs?

Scott W. H. Seu
President, CEO & Director

That is only fourth generation, right? I'm sorry, go ahead, Shelee. You can clarify it.

Shelee M. T. Kimura
President, CEO & Director

I'll let Colton answer that.

Colton K. Ching
Senior Vice President of Planning & Technology

This is Colton Ching from Hawaiian Electric. Yes, so the generation PIM, reliability PIM, encompasses both utility-owned as well as third-party IPP generation performance in total. But as Scott mentioned, it is for generation caused events separate from the existing or the previous transmission and distribution PIM that we currently have.

Paul Patterson
Glenrock Associates LLC

Okay. So the reliability of third parties, you will be incentivized to I guess, make sure that they're performing. Is that the idea? I mean, I guess what -- the slight concern might be is that it's not completely in your control, I would think? Or how should we think about that?

Colton K. Ching

Senior Vice President of Planning & Technology

Yes. Yes. So Paul, it is a different way, right? In which we'll need to manage the performance and reliability of independent power producers. But because of Hawaii's situation where our IPPs are long-term partners with us, we have, for many years now, have had contracts with -- very critical performance requirements and how we manage the reliability and operation of those facilities as well as having the right kinds of partnerships with our IPP so that they, to understand the role that they have in keeping always grids reliable. The reliability also comes from how our system operators dispatches the entire fleet of generation, the combination of independent power producers as well as our units as well.

Operator

There are currently no questions in the queue. [Operator Instructions] As there are no further questions in the queue, I would like to pass it back to the management team for any closing remarks.

Julie R. Smolinski

Vice President of Investor Relations & Corporate Sustainability

Thank you, everyone, for joining us today. And please do let us know if any further questions come up later on. Have a great week. Thanks.

Operator

This concludes the Q2 2022 Hawaiian Electric Industries, Inc. Earnings Conference Call. Thank you for your participation. You may now disconnect your lines.

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