

## **DECISION MEMORANDUM**

**TO: COMMISSIONER KJELLANDER  
COMMISSIONER SMITH  
COMMISSIONER HANSEN  
COMMISSION SECRETARY  
COMMISSION STAFF  
LEGAL**

**FROM: SCOTT WOODBURY**

**DATE: AUGUST 27, 2004**

**SUBJECT: CASE NOS. IPC-E-03-16 (Idaho Power);  
AVU-E-03-9 (Avista); PAC-E-03-13 (PacifiCorp)  
MODIFICATIONS TO PURPA CONTRACT SECURITY PROVISIONS  
IDAHO POWER PETITION FOR RECONSIDERATION/  
CLARIFICATION OF FINAL ORDER NO. 29482**

On November 5, 2003, Idaho Power Company (Idaho Power; Company) filed a Petition with the Idaho Public Utilities Commission (Commission) requesting authority among other things to eliminate the second lien requirement as a risk mitigation measure in PURPA Power Purchase Agreements containing levelized avoided cost rates. Staff objected to the proposed elimination of the second lien requirement noting that without a second lien, PURPA Qualifying Facilities (QFs) desiring levelized rates must post 35% liquid funds as security for the calculated overpayment that results from the front-end loading that occurs with a levelized rate structure. Idaho Power in reply comments represented that should the Commission continue with the second lien requirement the Company intended to outsource the legal work and requested that it be permitted to collect the estimated \$1,000-1,500 cost directly from the QF or alternatively recover the lien expense as part of its annual Power Cost Adjustment (PCA) filing. Addressing this issue of cost recovery, Staff contended that this was a contract administration cost and has never been a cost directly billed to QFs; nor was it the type of power cost that was appropriate for recovery through the PCA. Staff opposed the direct billing of this cost to QFs or the recovery of same through the PCA.

On April 27, 2004, the Commission issued final Order No. 29482 in Case Nos. IPC-E-03-16, AVU-E-03-9, and PAC-E-03-13. In its Order the Commission denied Idaho

Power's request to eliminate the second lien requirement as a risk mitigation measure for PURPA Power Purchase Agreements containing levelized avoided cost rates. For new levelized contracts the Commission authorized the Company to recover its lien expense from the contracting QFs; or alternatively, permitted a QF to prepare the lien documentation and file the lien itself.

On May 17, 2004, Idaho Power filed a Petition for Reconsideration (IDAPA 31.01.01.331) or in the alternative a Petition for Clarification (IDAPA 31.01.01.325) regarding the portion of Commission Order No. 29482 that provides the option for QFs to prepare and file the lien or security interest documentation. The specific Order language of concern to the Company is the following:

The Commission continues to find value for ratepayers in the presence of a second lien to secure overpayment liability. We recognize that securing a lien may entail some expense. We assume the Company's decision to outsource is based on a determination that the utility has no in-house expertise or that the cost of outsourcing the task is less than performing the task itself. The Commission finds that it is inappropriate to recover this type of expense as part of the Company's PCA. We find it reasonable, however, for the Company to assess this cost to QFs. Alternatively, we find it reasonable that the QF be permitted to prepare the lien documentation and to file the lien itself. The procedure that we approve for recovery of lien expense is for new levelized PURPA contracts only.

Order No. 29482, p. 12.

Idaho Power states that it understands the Commission's desire to minimize QF transaction costs, however, the Company is concerned with the conflict of interest created by allowing QF developers to prepare and file the documents needed to secure Idaho Power's security interest in the assets of their respective QF projects. Idaho Code, Title 28, Chapter 9, the Company notes, sets out very precise documentation and filing requirements to protect security interests. If the requirements are not filed precisely, the security interest is not perfected and is subject to attack in the event of competing creditors seeking to foreclose on the QF's assets. The QF's failure to correctly document, perfect and maintain its security interest in QF project assets would jeopardize the Company's ability to maintain a priority creditor position on the assets covered by the security interest.

Idaho Power maintains that QF developers do not have a proper incentive to do a thorough job of creating and perfecting Idaho Power's security interest. If the Commission still

desires to provide this option to QF developers, Idaho Power requests that the Commission clarify Order No. 29482 by requiring that QF developers electing to prepare and file the lien documentation must permit the Company to review and approve all aspects of the creation of the security interest. The Company also requests that the Commission clarify that if the QF exercises this option to self file, Idaho Power will have no obligation to take remedial steps if the QF developer fails to adequately cover all project assets or fails to file any required continuation statements to maintain the viability of this security interest over the full-term of the contract.

Idaho Power notes that the recommended review and approval procedure of the second lien documentation prepared by QFs will require the Company to incur additional legal expense. Nevertheless, Idaho Power believes the initial review and approval by Idaho Power is necessary to at least reduce the likelihood of potential problems if a QF project experiences financial problems.

Of further concern to the Company, the Commission's final Order No. 29482 also contains the following language:

...For existing levelized PURPA contracts, the Company is expected to administer its contracts in a responsible fashion and to require QF compliance with Commission –292 security requirements. For those levelized QF contracts without a second lien, the QF should be brought into compliance or the Company should require a posting of liquid security. The Commission expects the Company to follow Commission Orders. Reference *Idaho Code* § 61-706. If liquid security is required but not enforced, it is the Company and not its customers that are at risk for the foregone security.

Order No. 29482, p. 12.

Idaho Power believes that it is unreasonable for the Commission to require the Company to accept a security interest created by the QF developer and then put the Company at risk if those security interests are not enforceable or do not cover all of the assets associated with a QF project. If the Commission gives QF developers the option to prepare and file the documents needed to perfect Idaho Power's security interest in the QF's assets, the Company believes that it should be relieved of any liability, even if it has review and approval authority, if it is ultimately determined that the security interest provisions of the Commission's –292 security requirements do not cover all of the QF assets or cannot be enforced.

On June 9, 2004, the Commission issued Order No. 29515 granting reconsideration and establishing a schedule for comment. As part of its reconsideration, the Commission noted that its seminal decision to authorize recovery from QFs of Company legal expenses related to second liens is also at issue.

Comments were filed by Idaho Power, Avista and Commission Staff. The comments can be summarized as follows:

**A. Second Lien Requirement – QF Option to Self-Perfect**

*Idaho Power*

On Reconsideration Idaho Power presents two alternative options: (1) that the Commission eliminate the self-perfection option; or (2) provide Idaho Power the right to review and approve the QF's documentation and perfection option.

For either a first or a second lien to have any value, upon default, the lien holder, Idaho Power contends, must be able to step into the shoes of the QF developer-owner as soon as possible and take over operation and maintenance of the project. Property involved in the QF project generally involves several different types of property, i.e., real property, fixtures, personal property, and other property such as property and equipment leases, fuel supply contracts, easements, rights-of-way, etc.

In Order No. 29482, the Commission stated its assumption that the Company's decision to outsource the preparation and perfection of its second lien was based either on a determination by the Company that it was not comfortable using its in-house legal counsel to prepare and perfect QF second liens or a determination by the Company that the cost of outsourcing the task was less than performing the task itself. Both assumptions, the Company states, were correct. Secured transactions involve specialized areas of the law that are constantly changing. Another major part of secured transactions laws is the effect of bankruptcy on loan security. Bankruptcy law, the Company states, is a very specialized legal practice and missteps often lead to loss of priority. For all of these reasons, the Company has concluded that outsourcing the legal work associated with QF second liens to legal counsel that specialize in secured transactions and bankruptcy law is a prudent course to follow to protect the interest of both the Company and its customers.

Allowing the QF developer to self-perfect the second lien, Idaho Power contends, presents a conflict of interest. Idaho Power understands the Commission's desire to reduce the

transaction cost to the QF associated with the second lien process. It is not Idaho Power's intent to make the process more complicated or more expensive than is reasonably required to protect the Company and ultimately its customers. That being said, Idaho Power is concerned that giving the QF the option to document, prepare and perfect a second priority security interest to attach to the QF's own property, presumably on behalf of Idaho Power, presents an inherent conflict of interest. Mortgages, deeds of trust, and security agreements often include notice provisions, default provisions, representations, warranties and definitions that could place the drafting QF's interest at odds with those of Idaho Power. Security instruments deemed adequate by a debtor may justifiably be viewed as deficient by a secured creditor. Moreover, the priority of a security interest perfected by filing or recording, as is the case with security interests in real property, fixtures and most personal property, depends in large part on the date and time of filing/recording. Idaho Power is concerned that allowing QF developers to control the filing/recording of these security instruments may further jeopardize Idaho Power's position.

Unfortunately, the Company states, the only time the quality of QF developer self-perfected second lien interest will be truly tested is when the QF project has defaulted. When the QF fails to perform the requirements of the Firm Energy Sales Agreement, defaults on various loans and other credit arrangements can occur. In that event, the filing of additional liens by other creditors, the filing of foreclosure actions associated with those liens, and ultimately the filing of bankruptcy by the QF are distinct possibilities. At any of those points and times, the validity of all of the liens is closely examined by the creditors, the bankruptcy trustee and others who have an interest in having higher priority security interests set aside so that their particular debt is more likely to be paid. If the lien is improperly documented or perfected or maintained and is set aside, or if its priority is compromised, the bankruptcy trustee and other potential junior creditors, including any equity participants in the QF project will benefit.

If the Commission does not eliminate the QF self-perfection option, at a minimum, Idaho Power states, that it should be permitted to review and approved the second lien instruments and confirm that the second lien interest was properly perfected in accordance with Idaho law and in a timely manner. The Company requests that the Commission bear in mind that this option will essentially double the legal expense associated with second lien transactions. The QF will be required to pay its legal counsel to prepare the second line documents and Idaho Power will be required to pay its legal counsel to review and approve the second lien documents.

### *Commission Staff*

Staff concludes that the -292 Second Lien Security Requirement is not broken, continues to be of value and requires no elimination, adjustment, modification or fix. Staff recommends that the Commission rescind its earlier decision to permit QFs to self prepare and perfect second liens. Staff in comments notes that in response to a production request the Company identified 25 projects with levelized rates that are subject to the Commission's -292 Second Lien Security Requirements. All of the projects with the exception of one have an existing and filed second lien. The one exception elected to post liquid security in the form of a letter of credit. Staff concludes that the -292 Second Lien Security Requirement was not broken, continued to be of value and required no elimination adjustment, modification or fix.

Staff believes that Idaho Power's arguments are compelling for eliminating the QF option to self-perfect second liens. By not allowing the self-perfection option, Idaho Power can avoid incurring additional legal expense that would otherwise be necessary for review and approval of second liens perfected by the QF. In addition, removing the self-perfection option will alleviate the Company's concern about risk if those security interests are not enforceable or do not cover all of the assets associated with a QF project.

### *Avista Corporation*

Avista recommends that creation of second liens on QF projects be handled in a manner similar to common commercial and real estate transactions. In those transactions, the party receiving the benefit of the lien or mortgage may prepare and file the lien or mortgage documents, or select the attorney or closing agent who performs the required legal work. In other situations, a person or law firm who is neutral to the seller and the buyer performs the legal work associated with creating the lien. Although the person whose property is to be encumbered is responsible for executing appropriate documents, only in the most exceptional circumstances is that person actually tasked with the responsibility of preparing and filing the appropriate documents that create the lien. Allowing QF developers to prepare and file the required documents, Avista contends, would be an unnecessary departure from usual commercial practice.

### **B. Recovery of Second Lien Legal Expense**

#### *Idaho Power*

Because QF developers obtain significant financial benefits from rate levelization, Idaho Power believes that it is appropriate for the Company to receive reimbursement for legal

expenses it incurs to secure the significant loan that rate levelization represents. Idaho Power states that it has negotiated a favorable rate for legal services associated with perfecting the second lien on QF assets. Unless the QF is uncooperative or is using some very exotic financing scheme, the legal expense will be in the \$1,000 to \$1,500 range.

If the Commission elects the review and approval option, Idaho Power requests that the Commission acknowledge that the legal expenses that Idaho Power incurs to review and approve the documents prepared by the QF are not unusual or one-time expenses and the Commission should authorize the Company to defer those legal expenses for recovery in a future revenue requirement proceeding, preferably as a QF purchase power expense in the Company's PCA.

*Commission Staff*

Regarding cost recovery of legal expenses incurred in preparing and perfecting second liens, Staff recommends that the Commission rescind its decision permitting Idaho Power to recover the cost of legal expenses incurred in preparing and perfecting second liens, directly from QFs, regardless of whether the legal work is performed in-house or outsourced. Staff contends that the legal expenses of preparing and perfecting a second lien, whether done in-house or outsourced, is a contract administration cost and has never been a cost directly billed to QFs. Staff opposes the direct billing of this cost to QFs. The legal costs attendant to securing a second lien are an operating expense appropriate for consideration in rate case revenue requirement calculations.

*Avista Corporation*

Avista concurs that a utility should recover in its rates costs relating to preparing and/or reviewing second liens. Alternatively, Avista contends that the costs of preparation and/or review of such liens should be directly reimbursed by the developer.

**C. Responsibility for Problems Arising Out of QF Self-Perfected Second Liens**

*Idaho Power*

Idaho Power understands that it is responsible for acting prudently when it undertakes any action in compliance with the Commission's Orders. However, the Company believes it is unfair for the Commission to allow QFs to self-perfect security interests in their own property and then hold the Company responsible if those security interests are not sufficient

to preserve the validity or priority of the lien. The same holds true, the Company maintains, even if it has review and approval rights.

*Avista Corporation*

If QF developers are assigned the task of preparing, filing and perfecting a second lien for a utility, then the utility, Avista contends, should not be held responsible for the viability of that security. It would be unreasonable, it states, to require a utility to accept a security interest created by a QF and then hold the utility responsible, if the security interest is not ultimately effective, enforceable or sufficient to cover all of the assets.

**Commission Decision**

Idaho Power requests that the Commission (1) eliminate the self-perfection option created in Order No. 29482 or (2) alternatively allow Idaho Power to review and approve the security interest documentation and perfection process as a condition of contract compliance on the part of the QF. Idaho Power contends that the Company should not be held liable for any failure or loss of priority of the second lien security interest arising out of the QF self-perfection of its security interest on its own property on behalf of Idaho Power. Idaho Power maintains also that it should be permitted to recover from the QF developer legal expenses it incurs in developing and perfecting the second lien security interest required as a condition of the QF being paid levelized rates.

Staff recommends that the QF option to self-perfect be eliminated. Staff also recommends that the utility be denied direct recovery of second lien legal expense from the QF or through the PCA.

Avista recommends that the QF option to self-perfect be eliminated. Avista recommends that a utility be allowed to recover in its rates costs related to preparing and/or reviewing second liens. Alternatively, Avista supports direct reimbursement of such costs by the QF.

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Scott Woodbury

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