

BARTON L. KLINE, ISB # 1526
MONICA B. MOEN, ISB # 5734
Idaho Power Company
1221 West Idaho Street
P. O. Box 70
Boise, Idaho 83707
Telephone: (208) 388-2682
FAX Telephone: (208) 388-6936

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IDAHO PUBLIC
UTILITIES COMMISSION

Attorneys for Idaho Power Company

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF A PETITION FILED BY)
IDAHO POWER COMPANY FOR APPROVAL) CASE NO. IPC-E-03-16
OF MODIFICATIONS TO THE SECURITY)
PROVISIONS REQUIRED TO BE INCLUDED) IDAHO POWER COMPANY'S
IN AGREEMENTS BETWEEN IDAHO) INITIAL COMMENTS ON
POWER AND CO-GENERATORS) RECONSIDERATION
AND SMALL POWER PRODUCERS)
_____)

Background

In Order No. 29482 issued in this case on April 27, 2004 ("the Order"), the Commission determined that it would continue to require PURPA qualifying facilities ("QF's") that desire to receive levelized rates to either (1) post liquid security (cash or cash equivalents) in an amount equal to thirty-five percent (35%) of the overpayment liability associated with the levelized rate structure; or (2) allow Idaho Power Company ("Idaho Power" or "the Company") to place a second priority security interest ("second lien") on the QF's projects assets.

For new levelized rate QF contracts, Order No. 29482 authorized Idaho Power to recover its legal expenses associated with preparing and recording

("perfecting") the second priority security interest from the contracting QF's; or, alternatively, the Order permitted the QF itself to prepare and perfect the second lien that would attach to the QF's property ("self-perfection").

Idaho Power filed a timely Petition For Reconsideration, or in the Alternative, a Petition For Clarification, regarding the portion of Order No. 29482 that provides the option for QF's to self-perfect the second lien on its own property for the benefit of Idaho Power.

The Commission granted reconsideration on June 9, 2004 and permitted the Company to file written comments in support of its Petition. In addition to the items the Company identified in its Petition For Reconsideration, the Commission, *sua sponte*, decided to reconsider its decision to allow Idaho Power to recover from QF developers the legal expenses the Company will incur to prepare and perfect its second priority security interest in the QF generating project.

In its Petition for Reconsideration or Clarification, the Company presented two alternative options: (1) that the Commission eliminate the self-perfection option; or (2) if the self-perfection option is retained, Idaho Power would have the right to review and approve the QF's documentation and perfection process.

In granting reconsideration in Order No. 29515, the Commission did not identify which of the two above-described options on which it desired to receive comments. Therefore, Idaho Power will address both options. Idaho Power will also explain why it believes it is fair for the Company to receive reimbursement of the legal expenses it incurs in preparing and perfecting the second priority lien that will attach to the QF facility.

I.

**Levelized Rates Are A Loan From
Customers To QF Developers.**

The Commission has previously determined that paying QF's on a levelized basis is in the public interest because it encourages the development of QF projects. Levelized payments involve paying the QF a price that exceeds the utility's projected avoided cost in the early years of the term of the Firm Energy Sales Agreement ("FESA") and paying the QF rates that are less than projected avoided costs in the later years. The stream of payments, on a present value basis, is computed to be financially equivalent to the unlevelized avoided cost purchase prices. The Federal Energy Regulatory Commission ("FERC") rules governing the setting of QF rates specifically authorized state commissions to use levelized rates in setting avoided costs. (18 CFR § 292.304(b)(5)).

Paying levelized rates to QFs means that the Company and its customers are making long-term loans to the QF developers. For large QF projects, this loan can be tens of millions of dollars.¹ Rate levelization also allows the QF developer to improve its cash flow and allows the QF developer to utilize a higher amount of leverage, i.e., use more debt than equity in putting together its project.

If the QF project successfully completes the full term of the FESA, customers are indifferent. If the QF does not successfully complete the full term of the FESA and the QF is unable to repay the loan created by the payment of levelized rates,

¹ When Boise Cascade closed its Emmett QF facility and terminated its FESA with Idaho Power, Boise Cascade paid Idaho Power \$4 million to repay the overpayment liability associated with its receipt of levelized rates.

Idaho Power's customers can be disadvantaged. This is why the Commission has ordered QFs to provide security for overpayment liability.

It's also important to note that in most instances, QF projects are developed on a "project finance" basis. The QF developer creates a single-purpose entity to own the QF project and the FESA with Idaho Power provides most of the credit support for the project loan. As a result, there is usually no recourse to any assets other than the generating project itself. The first priority secured interest lender can negotiate other security arrangements as a condition of making its loan to the QF developer. By Commission Order, Idaho Power is limited to either the 35 percent liquid security deposit or a second priority security interest. Not surprisingly, no QF project of any size has ever offered to post the cash deposit to avoid the second lien requirement.

II.

Perfecting and Maintaining A Valid Second Priority Security Interest Is A Complex Legal Process.

To better understand Idaho Power's concern with giving the QF developer the right to self-perfect a second priority security interest on its own property, on behalf of Idaho Power, it's important to briefly discuss what is involved in obtaining a security interest in property.

For either a first or a second lien to have any value, upon default, the lien holder 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 a QF project generally involves several different types of property. As described below, each type of property requires a different legal process for obtaining a security interest in that property.

Real Property

A security interest in real property generally involves either a mortgage or a deed of trust. Mortgages and deeds of trust are separate and distinct security instruments, each with its own statutory and contractual requirements and with very different methods of foreclosure. Recognizing that real property is the largest asset many people ever own, the law governing foreclosure of mortgages and deeds of trust requires strict adherence to all of the notice and other requirements set out in the Idaho Code. Idaho case law is replete with situations where the secured creditor's failure to precisely follow the statutory requirements, as those requirements have been interpreted by multiple court decisions, ultimately resulted in loss of priority and failure of the secured creditor to obtain the relief it expected to receive at the time it loaned the money to the debtor.

Fixtures

This is a hybrid between personal property and real property for certain types of equipment that is affixed to real property. Turbines, generators and power poles are all examples of fixtures. Fixtures have their own unique documentation and perfection procedures specified in Title 28, Chapter 9, of the Idaho Code.

Personal Property

This is property that is neither real property nor fixtures. Title 28, Chapter 9, of the Idaho Code generally governs the creation and perfection of security interests in this type of property. The requirements for filing and perfecting a security interest in personal property are specific and failure to precisely follow all the steps will

result in the security interest losing its priority or not being enforceable in a bankruptcy proceeding.

Other Property

In addition to the three types of property described above, almost every QF project involves other kinds of property or rights that must also be addressed if the first or second lien holder is going to have any chance to realize value from its security interest in the event of the default by the QF developer. These would include property and equipment leases, fuel supply contracts, easements, rights-of-way and a myriad of other miscellaneous contracts and interests in property.

III.

**The Company Will Use Outside Legal Counsel
To Prepare Security Interests For QF Projects.**

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 were correct.

Secured transactions involve specialized areas of the law that are constantly changing. The Idaho legislature recently made numerous changes to the laws governing secured transactions in the state of Idaho.

Another major part of secured transactions law is the effect of bankruptcy on loan security. Bankruptcy law 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 the prudent course to follow to protect the interests of both the Company and its customers.

It should be noted that first priority lenders almost always include the costs they incur for legal fees as a cost of QF loan transactions. The QF developers pay the first lien holder's legal expenses directly or as additional principal. Because QF developers obtain significant financial benefits from rate levelization, Idaho Power believes it is appropriate for it to receive reimbursement for legal expenses the Company incurs to secure the significant loan that rate levelization represents. Idaho Power has negotiated a favorable rate for legal services associated with perfecting the second lien on the QF assets. Unless the QF is uncooperative or is using some very exotic financing scheme, the legal expense will be in the \$1,000 - \$1,500 range.

IV.

Allowing the QF Developer To Self-Perfect The Second Lien Presents A Conflict of Interest.

The process of preparing the necessary security instruments and perfecting the second lien security interest to attach to the various types of property usually associated with the QF facility is complex. Idaho Power understands the Commission's desire to reduce the transaction costs 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 interests 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 upon the date and time of filing/recording. Idaho Power is concerned that allowing QF developers to control the filing/recording of the security instruments may further jeopardize Idaho Power's position.

Unfortunately, the only time the quality of the QF developer's self-perfected second lien interest will be *truly* tested is when the QF project has defaulted and all of the creditors are fighting over the assets of the failed QF project.

When the QF fails to perform the FESA, 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 in time, 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.

This is when the second lien prepared by the QF developer on behalf of Idaho Power will be scrutinized very closely. Inevitably, one of the other creditors will argue that it should lose its priority. 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.

Of course, at that time Idaho Power's prior ability to demand 35% liquid security or declare a breach of the FESA if the QF does not post the required 35% liquid security is a worthless contract right. If the QF project has reached that level of distress, it is very unlikely that other assets exist to satisfy the overpayment liability owed by the QF to Idaho Power. Allowing the QF developer to self-perfect presents a basic conflict of interest. The equity owners of the QF could actually benefit if the second lien is defective. The small savings in legal expenses for the QF is simply not worth the risk.

In its Petition, the Company presented an alternative for the Commission's consideration. The Company noted that if the Commission still desired to give QF developers the option to self-perfect the second lien on the property on behalf of Idaho Power, at a minimum, Idaho Power should be permitted to review and approve the second lien instruments and confirm that the second lien interest was properly perfected in accordance with Idaho law and in a timely manner. While Idaho Power believes this is still a potential option the Commission should consider, the Company requests that the Commission bear in mind that this option will essentially double the legal expense associated with second lien transactions. Undoubtedly, the QF will be required to pay its legal counsel to prepare the second lien documents and Idaho Power will be required to pay its legal counsel to review and approve the second lien documents. If the Commission elects this review and approval option, Idaho Power requests that the

Commission acknowledge that the legal expenses 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 Idaho Power to defer those legal expenses for recovery in a future revenue requirement proceeding, preferably as a QF purchase power expense in the Company's Power Cost Adjustment.

V.

Idaho Power Should Not Be Held Responsible For Problems Arising Out of QF Self-Perfecting Second Liens

On page 12 of Order No. 29482, the Commission cautions the Company that if the Company fails to enforce QF compliance with the Commission's security requirements, it will be Idaho Power and not Idaho Power's customers that will be at risk for the foregone security. Idaho Power understands that it is responsible for acting prudently when it undertakes any action in compliance with the Commission's orders. However, Idaho Power believes it is unfair for the Commission to allow QF's to self-perfect security interests in their own property and then hold Idaho Power responsible if those security interests are not sufficient to preserve the validity or priority of the lien.

If the Commission believes it is in the public interest for QF developers to have the option to self-perfect, then it should also acknowledge that it is inequitable to hold the Company responsible for the QF developer's actions. It would be particularly egregious for the Commission to hold the Company responsible for the validity or priority of a second lien security interest when the QF developer may be economically advantaged if the second lien is invalid or if its priority could be set aside as a result of errors or delay by the QF in perfecting the security interest.

While giving Idaho Power the right to review and approve the security documents and the perfection process is an improvement over the self-perfection option, it still does not give Idaho Power the degree of control over the process that should impose liability on the Company. Review and approval is definitely of lesser value than performing the actual preparation and perfection. The Company believes that it would also be unfair to hold Idaho Power responsible for an inadequate second priority lien if it only has review and approval authority.

Conclusion

Based on the foregoing, 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.

Under either scenarios (1) or (2) above, 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's self-perfection of the security interest on its own property on behalf of Idaho Power. Idaho Power should also 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.

DATED at Boise, Idaho, this 9th day of July, 2004.



BARTON L. KLINE
Attorney for Idaho Power Company

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 9th day of July, 2004, I served a true and correct copy of the within and foregoing IDAHO POWER COMPANY'S INITIAL COMMENTS ON RECONSIDERATION upon the following named parties by the method indicated below, and addressed to the following:

Scott Woodbury
Deputy Attorney General
Idaho Public Utilities Commission
472 W. Washington Street
P.O. Box 83720
Boise, Idaho 83720-0074

Hand Delivered
 U.S. Mail
 Overnight Mail
 FAX (208) 334-3762



BARTON L. KLINE