GDS ASSOCIATES, INC.

engineers and consultants

Independent Review of Assessment of Strategic Options

(Phase I Report)

Prepared For:

Beartooth Electric Cooperative, Inc.

Beartooth Electric Cooperative, Inc.™

Prepared By:

GDS Associates, Inc.
1850 Parkway Place, Suite 800
Marietta, Georgia 30067
770.425.8100 | 866.611.3791 fax
www.gdsassociates.com

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1.0 INTRODUCTION AND BACKGROUND

For several years, Bearthooth Electric Cooperative, Inc. ("BEC") has been struggling with major challenges, particularly extremely high wholesale power costs, but also the costs of local operations and the ability to maintain affordable and reasonably competitive rates to its members. Consequently, the BEC Board has been considering various strategic options for its future, including an acquisition by Northwestern Energy ("NWE"), a merger with Lower Valley Energy ("LVE") – an electric cooperative, and more recently, a three-way consolidation with LVE and Fall River Electric Cooperative, Inc. ("FREC"), and a stand-alone option, among others, in an effort to reduce rates and improve service to its consumer-members in southern Montana and northern Wyoming. Several options have been pursued extensively and various studies and reports by reputable engineering and consulting firms have been developed to provide guidance to the decision making process. BEC's ultimate decision will have long-term ramifications, though, and whatever decision is made should be based on the best available information, including independent reviews of that information. To this end, BEC engaged GDS Associates, Inc. ("GDS") to perform an independent review of the information available to the BEC Board of Directors and to provide advice and guidance, based on such review.

BEC has provided a number of documents and e-mail communications to GDS, which have all been reviewed. In addition, several discussions have taken place between GDS representatives and Arleen Boyd, a member of the BEC Board, Chairperson of the BEC Board Risk Management/Due Diligence Committee, and as a representative of the group overseeing the independent evaluation that includes the LVE/BEC manager Jim Webb and Bill Pascoe, a member of the risk management committee and BEC Board.

The primary options that have been under consideration by BEC have been:

- Acquisition by Northwestern Energy
- Merger into Lower Valley Energy
- Management Agreement with Lower Valley Energy
- Consolidation of Lower Valley Energy, Fall River Electric Cooperative, and Beartooth
- Stand-Alone (maintain current autonomous operations)

The initial discussions with LVE have resulted in the execution of a management agreement with LVE, under which LVE is managing BEC. This Agreement became effective on April 26, 2015 and will continue for a three-year term, ending 4/25/2018. One of the conditions of the Agreement is that a merger be effected between LVE and BEC within three (3) years (by the end of the term of the agreement) or the management agreement terminates. BEC must make a decision as to whether to merge with LVE on or within 90-days prior to the end of the second year of the Contract or approximately between January 26 and April 26, 2017, and then consummate the merger by 4/26/18. Depending on the beginning point, BEC has approximately 6 - 9 months to make a decision concerning merger with LVE. If it decides against merger, BEC would need to have an alternate management plan in place by 4/26/2018, when the LVE management agreement terminates.

While efforts have been ongoing for some time, since the LVE management agreement became effective and LVE began management of BEC, an exit agreement was reached between BEC and its previous wholesale power supplier, Southern Montana Generation and Transmission Cooperative (Southern Montana) and BEC made its last payment to Southern Montana in June

2016. With LVE's assistance, BEC has been able to enter into a 7-Year wholesale power supply arrangement with Morgan-Stanley and Twin Eagle Resource Management, LLC, under which BEC's wholesale power cost will decline from approximately 7.0 cents per kilowatt-hour (kWh) purchased (and which would have risen even higher if BEC had not withdrawn from Southern Montana) to approximately 4.2 cents per kWh (energy and transmission), approximately a 40% reduction in power costs. The BEC Board's current focus is on achieving an operating plan that provides the most economical costs of distribution operations to members.

In considering various options for achieving long-term economical distribution operations and retail rate levels for BEC member-consumers, it should be noted that while some may believe otherwise, inefficient operations at BEC are not the problem in achieving lower rate levels. Rather, the main culprit, now that the power cost issue has been resolved, is low usage of electricity by BEC's consumers. To put this in perspective, a comparison to LVE, which is currently managing BEC, is helpful. As shown in the table in **Figure 1**, below, in 2015 LVE's average monthly usage per consumer of 2,232 kWh was 2.6 times the average monthly usage of BEC consumers of 859 kWh.

Figure 1

		Description	2015
1		BEC Annual kWh Sales	60,852,637
2		BEC Consumers	5,902
3		BEC Average Monthly Usage Per Consumer (kWh)	859
4		LVE Average Monthly Usage Per Consumer (kWh)	2,238
5		LVE Usage times BEC Usage	2.60
6		BEC Usage at LVE Usage Levels	2,238
7		BEC Usage at LVE Average Use	158,474,986
9		BEC Annual Operating Expense and Deductions	$4,514,489
10		Annual Operating Expense per kWh at LVE Usage Levels	$0.0285
11		BEC Operating Expense Per kWh Sold	$0.0742
		Reduction in Operating Expenses to Achieve	
12		**cost per kWh at LVE Usage Levels**	**($2,780,975)**
13		Remaining Available for Operating Expenses	$1,733,514
14		Depreciation and Interest Expense	$1,538,613
15		**Net Available for O&M, Cust Acct, and A&G Exper**	**$194,901**

If BEC consumers had the same average usage levels as LVE consumers, BEC's annual kWh sales in 2015 would have been 158 million kWh instead of the actual usage of 61 million kWh. Since BEC's distribution expenses are relatively fixed, dividing BEC's distribution operations expense by 158 million kWh would result in a cost of 2.86 cents per kWh, comparable to LVE's cost of 2.53 cents in 2015, as shown in **Figure 2** (line 3), below.

Figure 2

		Description	BEC			LVE
		(a)	(b)			(c)
1		TOTAL Operating Expenses and Deductions	$4,514,489			$18,233,372
2		Kilowatt-hours Sold	60,852,637			719,436,250
3		**Operating Expenses and Deductions per kWh sold)**	**$0.0742**			**$0.0253**
4		Consumers Served	5,902			26,794
5		**Operating Expenses and Deductions Per Consumer**	**$64**			**$57**
6		Miles of line	1,804			2,665
7		**Operating Expenses and Deductions Per Mile of Lin**	**$2,503**			**$6,842**

BEC's total non-power cost related operating costs in 2015 were $4.5 million. Reducing such costs to approximately 3.0 cents per kWh or about $1.7 million, would require a reduction of $2.8 million (Figure 1, line 12) in operating costs. Since depreciation expense and interest expense account for about $1.5 million, this would allow less than $200,000 for operations and maintenance, customer accounting (billing and records), or administrative costs (See Figure 1, lines 13-15). In view of this reality, it is not reasonable to expect that any options available to BEC will reduce operating expenses by such dramatic amounts. However, the combination of the much lower wholesale power cost, combined with somewhat lower operating expense that may be achieved through options under consideration, may result in rate levels comparable to or even lower than rates that would have been charged to BEC consumers by the local investor owned utility company, Northwestern Energy. The BEC Board must be mindful, though, that the current power cost arrangement is only a 7-year contract, after the expiration of which, another power supply plan--another major challenge--must be developed and implemented. The current challenge for the BEC Board, though, is to determine which, of the options available, can provide the lowest operating cost and the necessary capabilities, while assuring reliable service to BEC members. The following sections address the options that the BEC Board has been considering and also suggests some possible additional options for consideration.

2.0 LVE MANAGEMENT AGREEMENT

Overall, it appears that the current arrangement with LVE is working quite well and delivering the expected benefits. Continuing that relationship, even if it became necessary for BEC to pay LVE a higher fee, might be beneficial to both BEC and LVE, in spite of the distances between the BEC Headquarters in Red Lodge, MT and LVE offices in Afton and Jackson, WY and other draw-backs. Some consideration, though, must be accorded the effort by the BEC Board for oversight and management of the LVE Agreement, an effort which may not be sustainable. Also, the lack of on-site LVE oversight at BEC on a daily basis may prove to be a weakness, over time, as a sustained effort by LVE management will be necessary to achieve the expense savings and operational improvements deemed necessary to achieve operating cost savings and minimize rate levels. However, LVE has just assigned an LVE employee with management, staking (field line design), and member services experience to spend considerable time on-site, so this issue may have been adequately addressed by LVE.

2.1 LVE Management Agreement – Conceptual Agreement

The Conceptual Management Agreement that was developed as a precursor to the LVE management agreement was provided and has been reviewed. That agreement, which has now been largely incorporated into the executed management agreement appeared to be quite thorough with all major issues addressed. The LVE proposed charges for management services to BEC appeared to be very reasonable, for the services offered.

LVE's deadline imposed for a merger between LVE and BEC seems a bit artificial, though. If LVE is being properly compensated, the BEC management contract would seems to be a good business opportunity for LVE. The conceptual agreement also provided a 90-day cancellation provision for both parties, which would represent risks to both parties and could interfere with commitment levels. However, in the final executed agreement, this was extended to six (6) months, which is much more reasonable and practical.

The Conceptual Management Agreement also addressed the consolidation of the LVE and BEC Boards, in the event a merger is ultimately consummated by BEC and LVE, in which one (1) BEC Board Member would go on the LVE Board to represent a Beartooth "District". Since LVE currently has an odd numbered 7-person Board, representing approximately 1 Board Member for every 3800 consumers, adding 5,900 BEC consumers to LVE's 27,000 consumer base, a more appropriate representation of BEC consumers would be 2 added to the LVE Board, which would result in an odd numbered 9-person Board. Even with 2 BEC Board members added to the LVE Board, the BEC Board Members would represent only 22% of the Board. It must be noted that LVE expects to enjoy benefits of a merger with BEC and since the BEC Board would be giving up full control in a merger with LVE, appropriate BEC representation on the LVE Board should be accommodated. Although the Board representation on an LVE/BEC merged system was discussed in the Conceptual Agreement, this discussion was not addressed in the final executed agreement, but it will become an issue to be addressed in the considerations of a merger arrangement.

2.2 EES Report – Evaluation of LVE Management Agreement

The BEC Board has been very deliberate with each step it has taken and before entering into the LVE management agreement, commissioned a study by EES Consulting, a prominent and highly regarded consulting and engineering firm, to review the proposed agreement. This evaluation was completed in June 2014 and was provided to GDS for review.

The EES Evaluation was very through, with respect to its intended purpose. The assessments included in the report appear to be very realistic and reflect experience in providing consulting services for electric cooperatives, as EES does. The report properly notes that under the LVE management agreement, LVE should be able to shift some of its administrative/management expenses to BEC, which lowers LVE's operating expenses and the costs absorbed by BEC from LVE are lower than BEC could obtain such services in a stand-alone environment, so both parties should benefit from the agreement. The report also notes that LVE staff resources would be available to help manage power supply issues, although the 3-year term of the agreement does not provide for support to BEC in the development of follow-on power supply arrangements, after the end of the current BEC 7-year power supply contract, since LVE would no longer be available to BEC if a merger is not effected within the 3-year term of the agreement.

In the Economic Analysis of the report, EES attempted to quantify savings that could be achieved under the LVE management agreement. While some of the cost savings are likely related to capitalized costs and would not necessarily be reflected in reduced revenue requirements/rates, some of the LVE charges may also be capitalized, such as some of the engineering costs. So while it may not be appropriate to capture all of the savings as expense savings, as implied in Table 6 of the EES report, the savings estimates may actually be conservatively low and additional savings could likely be achieved through the expertise gained from LVE.

The savings from the LVE Management Agreement should probably be best considered in terms of the savings or reduction in revenue requirements on a "Per kWh" basis. As shown in **Figure 3**, on line 16, the savings of 1.3 cents per kWh is significant and certainly justified a decision by the BEC Board to enter into the LVE Management Agreement. Furthermore, it is believed that greater savings than this are possible under the LVE Agreement.

Figure 2

EES Report - Table 6 - Total Savings for BEC				
	(a)	**(b)**	**(c)**	**(e)**
		2015	2016	2017
1	Staff Reductions	$666,172	$679,495	$693,085
2	Material & Supply Contracts	$424,564	$433,055	$441,717
3	Warehouse Reductions	$82,321	$103,287	$125,059
4	Capital Cost/Competitive Bidding Savings	$289,993	$309,401	$231,324
5	Total Savings	$1,463,050	$1,525,238	$1,491,185
6	% Savings Realized	75%	100%	100%
7	Savings Realized	$1,097,288	$1,525,238	$1,491,185
EES Report - Table 7 - Net Impacts for BEC				
8	Less: Payments to LVE	$684,000	$703,494	$723,494
9	Net Savings to BEC	$413,288	$821,744	$767,691
EES Report - Table 8 - Rate Impacts for BEC				
10	Revenue Requirements Before Changes	$10,317,495	$10,381,476	$10,445,455
11	Less: NET SAVINGS	$413,288	$821,744	$767,691
12	Revenue Requirements After Changes	$9,904,208	$9,559,732	$9,677,764
13	kWh Sales	62,530,273	62,918,036	63,305,788
14	Average Rate Before Changes	$0.165	$0.165	$0.165
15	Average Rate After Agreement	$0.158	$0.152	$0.153
16	Difference	$0.007	$0.013	$0.012
17	% Difference	4.0%	7.9%	7.3%

Overall, the EES report was well done and addressed most of the significant potential areas of savings, although even greater savings may be achievable through the expertise of the LVE staff, and the report provided more than a sufficient basis for the BEC Board to enter into the LVE Management Agreement.

2.3 BEC/LVE Management Agreement

The executed LVE Management Agreement was reviewed and it appears that the final agreement tracked the conceptual agreement outline closely. The agreement is straight-forward and appears to be adequate and appropriate for the intended purpose. The Agreement does not seem to provide much room for ambiguities and certainly appears to reflect a "good faith" approach by LVE. As mentioned in Section 2.1 above, the notice period for cancellation was extended to six (6) months in the final agreement. BEC representation on the LVE Board, in the event of a merger between LVE and BEC was not mentioned in the final agreement, although the agreement does mention in Section 3.2 a "merger agreement", which presumably would address such matters.

As noted earlier, the charges are fair and reasonable which should provide for easily determined and understood invoicing by LVE. The "add-on" (or "direct bill services", as they are defined in the agreement) charges are also well defined and administering this portion of the contract should not present a challenge, but BEC will need to monitor and control the add-on charges. LVE will likely be sensitive to added charges, also, and will try to keep these to a minimum. As the parties gain experience with the Agreement, it may be possible to incorporate some of the items eligible for "add-on" charges into the Base Charge, which would simplify the administration of the Agreement. An alternative would be a report to the BEC members each year addressing the results on operations under the LVE Management Agreement.

LVE has long enjoyed a good reputation as a well-managed cooperative and that alone should provide encouragement and confidence to the BEC Board that it has joined hands with a worthy partner in entering into the LVE Management Agreement. While not considered a major priority, the BEC Board should consider the use of some performance measurement metrics to assure to itself and members that the Management Agreement is providing the intended results. This would also provide a tool for the Board to use to demonstrate that the Management Agreement is beneficial to the Members.

One draw-back to the LVE Management Agreement is the required involvement of the BEC Board, longer-term in the administration of an agreement. The BEC Board should consider how realistic it is for the Board or individual members of the Board to be so involved in the administration of the Agreement (along with the consideration of other strategic options). Consideration should also be given to the possibility of active Board members no longer being available, able, or willing, to be so involved in the process, in spite of the fact that for some time now, several Board members have been very active and dedicated in their efforts to assure the best possible future for BEC and its members, even though the BEC entity may not ultimately survive.

It should be particularly noted that the First Amendment to the Management Agreement, voluntarily offered by LVE, to credit BEC $30,000 per year for NISC charges that could not be achieved in savings to BEC due to lack of cooperation of NISC, is certainly a strong showing of good faith by LVE and must be acknowledged.

2.4 BEC/LVE Transition Plan

The BEC/LVE Transition Plan was also reviewed and its thoroughness is impressive and demonstrates the quality and capabilities of the LVE management team. Overall, the transition plan appears to cover just about every aspect of BEC's operations, and if the actual transition goes according to plan, the transition process should not be burdensome to the BEC employees and the BEC Board. In reviewing the plan, a few points were identified that deserve comment:

- The role of the staff assistant seems overly broad, but seems to be intended to be somewhat of a general supervisor and liaison to LVE (work orders, staking, customer service, member services, and human resources). Depending on the volume of work and capabilities of the individual, these are very broad responsibilities requiring a great deal of very detailed knowledge in a number of areas. Work order accounting and staking are very specialized activities. Staking (field line design), in particular, requires extensive training and on-the-job experience under an experienced mentor. If the intent is more in the vein of supervising these activities, the role of the person is more doable. Also, getting too involved in the details of any of the identified area, though, could interfere with providing oversight over all of the areas. However, LVE has just assigned an LVE employee who has the experience called for in this position, so for now, this may not be an issue of concern.

- Addressing the high line loss issue should be a high priority with every reasonable effort made to reduce the loss rate from approaching 14% to something below 10%, if realistically possible.

Overall, the transition plan appears to be a very good, very thoughtful, executable plan.

3.0 BEC/LVE MERGER

While it is unclear exactly how extensively the BEC and LVE Boards and Managements have discussed merger concepts, it is obvious that LVE and FREC have had extensive discussion on a potential LVE/FREC consolidation, as evidenced by the draft Memorandum of Understanding (MOU) that has been provided, but which has not been finalized and executed by LVE and FREC. Should a two-way merger/consolidation of LVE and BEC be considered and pursued, a MOU between the two (or as an alternative, the specific inclusion of BEC in the MOU between LVE and FREC) should be developed to outline the consolidation principles and plans. It is understood, at this point, that BEC has been invited by LVE and FREC to participate in a 3-way consolidation of the three cooperatives, but the existence of the requirement in the LVE Management Agreement for a decision by BEC by April, 2017 to merge with LVE and to actually consummate the merger by April 2018, after which the LVE Management Agreement terminates, clearly indicates LVE's desire for BEC to merge into LVE. This may be an excellent option for BEC for the long term, but it must be recognized and accepted by LVE and BEC that because of the differences in power supply arrangements between LVE and BEC, uniform rates between the current LVE and BEC service areas may never be a reality, although uniform rates for distribution service may well be possible. The BEC legacy area would likely need to be considered a "division" with a separate power supply plan for that area, the cost of which would be reflected in rates, such that rates in the BEC area would, for the foreseeable future, contain a charge for power supply that would be different and likely higher than the rates in the LVE legacy area, as it is not reasonable to expect the LVE area to heavily subsidize the BEC area by charging higher rates to LVE legacy consumers to offset the higher costs of serving the BEC legacy area.

3.1 EES report on Merger/Consolidation

EES has prepared a report of the benefits of the consolidation of LVE and FREC, and has also produced a report (April 2016, Draft 3) that would also include BEC in the consolidation. Overall, the report seems to be fairly thorough and seems to cover most of the major issues and concerns which typically arise in the consideration of a consolidation. However, as noted in the BEC Risk Management Committee review report (attached to Arleen Boyd's e-mail of 6/16/16), the merger impacts are not rolled all the way through the rate making process, such that the BEC Board can clearly compare the rates that would result from a consolidation of LVE, FREC, and BEC (or for that matter between LVE and BEC) to rates that would likely result in an acquisition by Northwestern Energy or a continued BEC stand-alone operation. While a detailed determination of rate structures and charges that would result from a consolidation of two or more cooperatives is a more challenging endeavor that may be perceived, the BEC Board cannot be expected to act in favor of a consolidation with LVE or LVE and FREC, without 1) at least a reliable indication of overall revenue requirement levels for the BEC legacy area, which would indicate the approximate level of rates that would be charged to BEC consumers, following a merger and 2) an agreement, as part of the consolidation agreement, that the rate concept would not later be altered by the consolidated entity, to the detriment of the BEC legacy consumers.

The "Summary, Conclusions, and Recommendations" section of the April 2016 EES report has not been completed in the draft provided to GDS, and while much interesting information is provided in the report, the clear results in terms of rate impacts to BEC consumers that would be experienced in a merger scenario, have not been produced. However, in an effort to provide some perspective, as addressed under Section 2.2, above, and in Figure 3, the estimated on-going savings associated with the LVE Management Agreement is in the range of 1.3 cents per kWh and will likely increase, somewhat, over time. It would be logical to assume that in a merger, even more of BEC current expenses could be reduced, such as some of the customer accounting and billing expense, along with certain administrative and general expense, such as costs of outside services, Board related expense, meeting and travel expense, insurance costs, dues and subscriptions, newsletter, annual meeting expense, etc. A pro forma financial analysis assuming a merger between BEC and LVE was prepared by Wade Hirschi, LVE CFO, and indicates additional net savings of approximately $300,000 annually due to the elimination of the BEC entity in a merger with LVE. That amount is equivalent to approximately 0.5 cents per kWh sold. Thus, if this is added to the approximately 1.3 cents per kWh savings from the LVE Management Agreement (Section 2.2, Figure 2), it would appear that a total cost savings on the order of 1.8 to 2.0 cents per kwh ($18 to $20 per month on a monthly bill for 1,000 kWh) could be achieved with a merger of BEC into LVE, and possibly more. However, there will be some costs incurred as part of a merger along with savings at LVE, so it is difficult at this point to assess exactly the rate impact to BEC consumers associated with a merger of BEC into LVE.

LVE also commissioned an economic analysis of consolidation of LVE and FREC by Energy + Environmental Economic (E3), which was provided and which has been reviewed in the preparation of this report. However, the results from the analysis are difficult to interpret in terms of transferring the results presented to the impact on BEC rates. More study and review of this report is probably warranted and it may need to be revised to incorporate the effect of BEC being included in the consolidation.

4.0 LVE/FREC/BEC CONSOLIDATION

As acknowledged in the draft LVE/FREC MOU that outlines the concepts for a consolidation of LVE and FREC, the idea of a merger between LVE and FREC has been debated for decades and, in spite of language in the MOU that the time may finally be right for a LVE/FREC merger, there is no assurance that LVE and FREC are going to come to terms anytime soon, which would allow the parties to move forward on a definite plan of consolidation. The concept of a 3-way merger (LVE, Fall River, and BEC) may sound appealing at first, but terms requested by FREC, such as protecting all of its Board members, may interfere with the benefits to be realized with an LVE/BEC Merger. There is also considerable uncertainty associated with FREC being able to withdraw from its wholesale power cooperative, PNGC, and the current draft of the MOU includes a provision that failure of PNGC to release FREC is a basis for termination of the MOU.

A merger of two cooperatives is very difficult and trying to get three to agree and have a good agreement and plan is almost impossible. The LVE/FREC proposed consolidation is likely to fall apart before being consummated but, in any case, the way the MOU is structured, BEC could be largely left out in governance issues. As mentioned earlier, at least 2 BEC board members and no more than about 4 FREC Board members should make up a consolidated board of about 13 (an odd number). If the Board is to be reduced to approximately 9 (as mentioned in the MOU), it would seem appropriate for LVE to have about 5 representatives, FREC to have about 3, and BEC to have 1, for a total of 9. LVE and FREC have been talking about a consolidation for years, and will likely to continue to do so. Also, playing “musical chairs” with the CEO (as also addressed in the MOU) is a questionable idea and appears to be nothing more than an accommodation of FREC, but could work against BEC, if the FREC CEO does not share the same interest in BEC as LVE’s Webb.

5.0 NORTHWESTERN ENEGY ACQUISITION

On 2/4/2016, via e-mail letter, the BEC Board advised NWE that BEC would not pursue an acquisition by NWE at that time. NWE provides service in the area in and around BEC’s service area, including the various towns in the area, and it is well known that the BEC Board has been in discussions with NWE concerning an acquisition of BEC assets by NWE. When those discussions began in 2012, BEC was in a very different situation that it is in today. At the time, BEC was dealing with an impossible power supply situation and the prospects of bankruptcy and the BEC Board believes that NWE had a sincere interest in assuming the service obligations for the BEC consumers through an acquisition of BEC electric transmission and distribution assets. Consistent with its obligations to perform adequate due diligence in the consideration of an asset acquisition by NWE, the BEC Board commissioned two valuation studies to determine the value of the BEC assets, should BEC entertain an acquisition offer. A valuation study done by EES indicated the value of the BEC assets to be $25.0 million. In the discussions between the BEC Board and NWE, the purchase price offered by NWE, from initial discussions and continuing through discussions in early 2016, was $17 million. Under the offer made by NWE, the purchase price offered by NWE would be recovered over ten (10) years from the BEC legacy consumers through a supplemental charge, added to the regular NWE charges under its standard rates, approved by the Montana Public Service Commission. According to information provided by NWE in early 2016, the proposed charges to BEC residential consumers, for example, would include a monthly supplemental charge of $31.06 per month. In this information provided by NWE, revised rate calculations were provided, in which NWE asserted that it had adjusted the BEC rate down by another 5%, which showed the total charges to be about even with the charge under NWE's rate with the supplemental charge included. This calculation does not appear to be correct, though, as the 5% reduction appears to have been applied only to the BEC energy charge. But even if it was accurate, the BEC rate should be decreased by at least another 10% to reflect an accurate comparison.

Mr. Bill Pascoe, a member of the BEC Board and the Board's Risk Management Committee (and also a professional energy consultant and former vice-president with NWE and its predecessor, Montana Power Co.), developed some rate comparisons under various scenarios. His analysis has been reviewed and verified as being accurate. In his analysis, he demonstrates that with the 10% rate reduction implemented by BEC in January 2016 and the additional 5% reduction later in 2016, the average BEC rate would be 13.231 cents per kWh compared to 15.248 cents per kWh under the NWE rates with the $2.5 million annual surcharge, 15.2% higher than the BEC rate. This difference of over 2.0 cents per kWh represents a difference of about $20 per month on a bill of 1,000 kWh usage.

While acquisition by NWE may have appeared to be attractive in 2012, the BEC Board has done its homework well and has made the correct decision to decline NWE offer to acquire the BEC assets and provide service to the BEC consumer-members.

6.0 OTHER OPTIONS

Some other strategic options may be available to the BEC Board, including Strategic Alliances, shares services agreements, or possibly mergers with other neighboring Montana electric cooperatives. Consideration of such additional options, will be time consuming and not without additional costs, though, and the deadline for a decision on a merger with LVE is approaching. Should a decision be made not to move forward with a merger with LVE, consideration of options such as these would be more realistic.

6.1 Strategic Alliance

Before BEC closes the door on its options for the purpose of making a decision, another option may be a "strategic alliance" with one or more other electric cooperatives in Montana or in neighboring states. A Strategic Alliance could be established in a number of ways, but an optimal structure would be for two or more cooperatives to create a third entity, the Alliance Cooperative (for lack of a better term), and consolidate as many functions as possible in the Alliance Cooperative (similar to the LVE Agreement). The Alliance Cooperative would be staffed with key personnel from the members of the alliance, such as General Manager/CEO, Chief Financial and Accounting Officer, Chief Operations and Engineering Officer, Chief HR Officer, Chief Information Officer, Chief Member Services Officer, etc. There should be a sufficient number of highly qualified personnel among the alliance members to staff the key positions at the Alliance Cooperative. There may even be surplus personnel who could be offered early retirement plans. Ideally, the GM/CEO of the Alliance would also be the GM/CEO of all of the alliance members, but this is not an absolute requirement and could be achieved over time. Everything but the basic day to day operations would be stripped out of the alliance members and consolidated at the alliance. However, each member of the alliance would retain its own Board, Bylaws, Rates, Service Rules and Regulations, Salary and Benefit Plans, etc. Over time, some uniformity could be established in terms of things such as Bylaws, Service Rules and Regulations, Rates, Salary and Benefit plans, but the Alliance Cooperative would have its own Board, bylaws, management structure, policies, salary and benefit plan, etc. The Alliance Cooperative would manage the operations of all the members of the Alliance, but an accounting system would be maintained for each member and the costs of operating the Alliance would be shared, pro rata, on an equitable basis among the members. Ideally, the operating costs of the alliance members would decline, even after charging back to each member, the costs of operating the alliance. Even if there are differences in power supply, lenders (RUS vs non-RUS borrowers), Union vs non-Union, etc., it would not prevent the Alliance from consolidating much of the operating functions of the members. There are other conceptual models that may work adequately, but BEC should consider this as another available option. There are some downsides to an alliance, though, and one of those is “commitment”. Once the parties agree to form an alliance, it should not be easy for a member to withdraw, since the only way the alliance can be effective is through the consolidation of operating functions of its members.

6.2 Merger with neighboring Montana electric cooperatives

The map of the service areas of the Montana electric cooperative shows that Beartooth is sandwiched in between Park to the west, Yellowstone to the east, and Fergus to the north. It would appear that a two, three, or four-way merger between some or all of these three other cooperatives may be a feasible option, although it may be much easier to establish an alliance or shared services agreements with some or all of these, but a merger/consolidation with some or all of these may be a feasible option. However, for various reasons, other neighboring electric cooperatives may have no interest in merging with BEC, so optimism about the possibility mergers with any neighboring cooperatives should be tempered.

7.0 SUMMARY AND CONCLUSIONS

Considering a number of strategic options can be a daunting task and if BEC elects to consider all reasonably available options, it should be prepared for a lengthy, somewhat expensive process. The dominant issue in all these options tends to boil down to “control.” How much control will the Cooperative lose in whatever option it ultimately selects? The loss of some control is inevitable in any option other than maintaining the status quo, so everyone must be prepared to accept that fact. And, quite frankly, that is likely the main reason that more mergers have not occurred. Typically, as long as parties think they have a choice, they tend to remain autonomous, and only when they feel that they have few options or no viable option, do mergers occur. This is not always the case, and in the LVE/FREC case, this appears to not be the motivation for consolidation.

From all appearances, the LVE Management Agreement is achieving the desired results and operational savings may actually exceed estimates. Unfortunately, though, if a merger agreement is not reached with LVE, BEC would lose the benefits of the Management Agreement by April of 2018. To maintain the benefits of LVE management, BEC may have no alternative other than to proceed with plans to merge into LVE. Both BEC and LVE appear to be strongly motivated to proceed in this direction and the probability of success in consummating a merger/consolidation seems high. But because the LVE/FREC consolidation remains on the horizon, if BEC proceeds along the path to merger with LVE, it should take steps to assure a proper and proportional representation for its existing members in the governance of the consolidated entity.

In terms of having the ability to compare rate levels to BEC consumers under each scenario considered, the simplest approach would likely be to use the CFC Compass Forecast and first prepare a Base Case, that would reflect a BEC stand-alone operation, and then progressively test the impact of alternatives, based on the savings produced, to the extent such savings can be accurately estimated. Ultimately, an allocated cost study may be necessary, as part of the consideration of merger options, to better understand the allocation of costs, particularly legacy costs associated with each participating cooperative, in the developing of rates for consumers in each legacy area. With respect to comparisons to NWE acquisition alternatives, comparison of rate levels is perhaps the more appropriate route, but consideration should also be given to NWE's future rate levels. Anything that would indicate a significant uptick in NWE's rate levels in the near term should be a warning sign, in view of BEC's fairly stable financial outlook over the next several years.

As outlined in Section 6.0, above, there may well be other opportunities available to BEC to achieve operational cost savings through alliances with one or more other cooperatives (similar to the LVE Management Agreement), shared services agreements, or possibly consolidation with one or more other cooperatives other than LVE or FREC, such as neighboring Montana electric cooperatives. Consideration of such options is hard work, though, and requires a high level of interest and commitment of all parties over a sustained period of time to evaluate the benefits of arrangements and then execute the plan to achieve the results. All of this should be seriously considered by the BEC Board, but with the understanding that merger into LVE may be the easiest and quickest route to achieving the Board's desired objectives.

With all options considered, though, the BEC will need to identify costs savings and be able to assure that outages will be minimized and responded to immediately when they do occur, what the rate levels will be, what services and programs will be available to BEC members, etc. And governance issues cannot be overlooked either, such as Board representation, bylaws, etc.

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GDS REPORT

Beartooth Electric Cooperative, Inc.

Independent Review of Assessment of Strategic Options (Phase I Report)

770.425.8100 info@gdsassociates.com www.gdsassociates.com

GDS Associates, Inc.
ENGINEERS & CONSULTANTS
1850 Parkway Place, Suite 800
Marietta, Georgia 30067