

Risk Management Report

Risk Management Meeting – March 22, 2016

Red Lodge Office

Committee Present: Bill Pascoe, Richard Nolan, David Peterson, Frank Willett, Jack Schutte, Judith Gregory, Roxie Melton, Arleen Boyd. **Board:** Julie Lindgren, Dan Dutton. **Electronic connection:** Jim Webb, Wade Hirschi, Rick Nkori, Angie Jennings. **Larry Martin call-in at 1:30.**

Jim Webb reported that the consolidation plans with Fall River Electric are under review as the co-ops reexamine the projected financial benefits following the PNGC denial of an exit for Fall River. Jim anticipates doing more comprehensive analysis of long-term benefits before both boards examine the opportunity further. This removes the pressure on BEC to complete a hurried analysis and make a final comparison of alternatives.

Bill Pascoe asked about the diversity benefits for LVE and FREC reflected in the consolidation study and Jim answered that they are not present if the co-ops are not managing BPA power supply together outside PNGC -- PNGC gets diversity benefits for all members collectively. Dave Peterson endorsed the existing management agreement timeframe that allows analysis over time and more time for more communication with members before taking a recommendation out for approval.

Consolidation Report -- Gail Tabone from EES Consulting gave an overview of the Consolidation Report for LVE, FREC, and BEC. The committee had many questions and areas where EES, the committee and management agreed changes need to be made for accuracy and clarity. Even though the consolidation may be significantly postponed there was agreement to make the changes to prepare for later examination of possible consolidation and to highlight aspects of the analysis that also would be reflected in a merger analysis update. Arleen and Bill Pascoe will collect points and suggestions from the committee for EES to use in a report update that will be available for the April committee meeting.

There were many questions about the power cost savings designation and where to reflect the estimated \$324,000 shown as BEC incremental savings in power supply by 2021. There was agreement that the BEC number is not a “power supply savings due to consolidation” but rather a projected revenue increase due to planned meter upgrades that will more accurately record power delivered to customers and reduce the amount currently attributed to line loss (operations improvements should reduce line loss as well). The improvement in revenue would be accomplished under the merger or standalone model, and the cost of the meter upgrades is not reflected in the savings calculation.

Most important for analysis is the projected impact on rates at BEC – because it is a primary criterion for evaluating all alternatives and because rate impact was the major factor used to evaluate the NorthWestern Energy acquisition alternative. We concluded that the NWE alternative would not get the necessary two thirds of BEC members to approve because for the first seven years rates would be higher than rates members would pay an independent Beartooth. To make comparative evaluations fairly and accurately we will need estimated rates under the remaining alternatives. The EES analysis for consolidation does not project rates. The current analysis does project a 5% cost savings for the consolidated co-op five years out: “Given that the percent savings reaches 5% by year 5 of the

consolidation, it is expected that rates can be reduced by an equivalent amount.” The report notes that there is no agreement as to how the rates would be differentiated by region but they likely would be set using independent cost of services analyses. The costs for the BEC region would include meter upgrades to achieve projected revenue increases and actual line loss savings. Additionally, BEC would incur approximately a \$1.5 million penalty cost for retiring RUS/FFB debt and becoming a CFC 100% borrower as both the consolidation and merger would require. It is important to understand how these costs would be factored into rate adjustments made by the consolidated co-op or by LVE after a merger.

For the upcoming April committee meeting the EES numbers will be clarified, BEC data added and verified, and the impact on rates quantified. The correction and addition of data will help the committee assess the draft comparison of merger and standalone numbers (the current one-year projection is based on the 2015 financials). The committee received the standalone/merger draft the morning of the meeting and Wade Hirschi and Jim Webb walked through the numbers. The committee agreed that having the consolidation update and having time to examine the merger/standalone numbers is necessary and should precede a possibly revised scoping for the engagement of the independent consultant.

Independent Consultant -- The board approved the recommendation to engage an independent consultant and Bill Pascoe and Arleen issued Requests for Services and received replies from three highly qualified candidates. The request letter asked for proposals to:

- (1) Evaluate Alternatives. This task consists of identifying and weighing the relative advantages and disadvantages of the strategic alternatives (standalone, merger/consolidation, and acquisition) in four primary categories:
 - a. Governance
 - b. Rates
 - c. Reliability
 - d. Member Services and Programs
- (2) Review Process. This task consists of reviewing Beartooth’s approach to identifying and evaluating strategic alternatives and identifying any additional alternatives or analysis that should be considered.
- (3) Provide Recommendations. This task consists of providing a written report with recommendations to Beartooth’s Board. This task may also include presenting the report and recommendations, by teleconference/webinar or in person, to Beartooth’s Board and Risk Management Committee.

The committee, following input from Jim Webb, suggests evaluating the scope of the analysis to accomplish the necessary baseline verification of the process, the NWE analysis, and the merger/standalone numbers with a possible postponement of a full review of the consolidation alternative pending evaluation of timing for consolidation by Fall River and Lower Valley.

Committee Next Steps –

- Provide feedback to Jim Webb and EES on the consolidation analysis
- Provide feedback on standalone report to prepare for discussion at April Risk Management meeting
- Confirm or amend scope for independent consultant review
- Engage independent consultant per board direction
- Examine upgraded reports at the April meeting
- Discuss definition of governance evaluation criteria.

Governance – The committee agreed that governance issues, part of the evaluation of alternatives, should be addressed at the next committee meeting.

Legal Report – Larry Martin called in to the risk management meeting to report on the Felt Martin memo to the board and explain the potential impact of legal findings to date that were addressed in a conference call with LVE counsel, Jim Webb and Arleen Boyd.

The BEC Bylaw Committee had asked about the provision in the LVE bylaws that the board may amend bylaws without a process for member notification and approval and whether such a provision is legal. Our counsel's initial opinion is that such a provision is not permitted under Montana code, which also says that a merger or consolidation must protect the rights that Montana members would have under Montana law. Larry advises that, should merger or consolidation be identified as the preferred alternative, a full review of the bylaws that would apply to BEC under the proposed merger or consolidation be conducted to identify all provisions that might not comply with Montana law. At the same time counsel would confirm their current opinion that BEC could only merge with a cooperative whose bylaws and other governing provisions protect member rights guaranteed under Montana law.

Our attorneys and LVE counsel agree that Wyoming law, which applies to Beartooth because of our Clark members, requires that a merger or consolidation be approved by a majority of the co-op members. Counsel reports that meeting both the Montana standard (two thirds of all members who vote) and Wyoming requirement (majority of all members) may be required for BEC.

Counsel at board meetings -- We are evaluating alternatives that could result in asking members to approve (or not) the most important decision ever made at BEC – closing Beartooth Electric Cooperative and merging or consolidating with one or more other entities where our members will represent a small percentage of the total membership and will be governed by bylaws and policies that may differ from those currently in effect at BEC. We have just seen an example of the value of knowing the legal ramifications of actions we are considering (the requirement for bylaws that govern after a merger or consolidation to protect rights present under Montana law) before taking action. Co-op wisdom (NRECA and other) says the board hires an attorney who reports directly to the board as ours does. Many co-ops (including BEC in the past) have their attorneys present at meetings. Both of the co-ops we currently are talking with about potential merger or consolidation have counsel present at their board meetings. As legal liaison I believe that it is prudent to have counsel present at meetings going forward.

Negotiation process – With the delay in the FREC/LVE potential consolidation we should have time to

evaluate alternatives and prepare to negotiate terms of an agreement the board may choose to recommend to members. Our history of negotiating professionally and successfully includes: our exit from Southern, individual issues with the bankruptcy trustee and court as the bankruptcy took its many turns, the management agreement with Lower Valley Energy, and the recent power contracts. In all cases the negotiation strategy and objectives were set by and routinely reviewed by the board. The negotiation team included the board representative(s), management and legal counsel. The process was conducted using recognized negotiation practices with deadlines set mutually and participants identified independently by the participating parties. If we get to the point of negotiating a merger or consolidation agreement with LVE, in addition to the board representative(s) we need fully involved counsel and the board should consider designating someone with a management experience, independent of LVE, to participate.

Bylaw Committee Report

Bylaw Committee Meeting—February 29, 2016 -- Red Lodge Office

Committee Present: Sharlene McComas, Mike Specht, Burt Williams, Joe Acciani, Jim Webb, Charles Sangmeister and Jim Webb on phone.

Objective: review and suggest changes to Article IV, Section 1, G and Article III, Sections 7, and 8.

The committee reviewed bylaw provisions identified by the board for review and their suggestions are being circulated back to the committee for review before further review by counsel and likely presentation to the board in April.

Article III, Section 7, C -- changes will provide for ballots to be counted by the BEC auditor before the annual meeting where they can be verified and recorded by the credentials committee. The objective is to make vote counting at the meeting more efficient.

Article IV, Section G – suggested changes will make clear that notice to members of action to incur long-term debt or enter power contracts will include sharing the intent and parameters of potential actions and remove the language that suggests that the actual proposals (bids) for power contracts must be shared.

The committee had reviewed the Lower Valley bylaws. Members discussed with Jim Webb their perception that the BEC bylaws are focused on member rights while the LVE bylaws are more focused on the rights and processes of the board. They noted the LVE provision allowing the board to change bylaws without member approval (or notification) was contrary to BEC bylaws and values and asked for review of whether such a provision is legal. Committee members recommend that the board look carefully at the governance issues relating to a merger – they are circulating a list of concerns for consideration by the board.

Jim Webb discussed merger and consolidation and shared developments that may significantly delay the consolidation proposal.

Arleen Boyd – Risk Management Chair, District 5 Trustee
Report to the Board, March 31, 2016