

MEMORANDUM

To: Lee A. Freeman
From: Nancy A. Temple
Date: October 1, 2013
Re: Southern Montana Electric

I. Scope and Purpose of Investigation.

Pursuant to the Trustee's direction, I investigated corporate conduct and financial transactions of Southern prior to and after the bankruptcy petition was filed. My investigation included review of the financial books and records of Southern, documents prepared by its accountants and independent auditors, contracts and related documents, and Southern's Board minutes and documents provided to the Board. I also considered materials provided by Southern's members and information from its general manager, accountant, employees and counsel.

II. Issues Addressed in Investigation

A. Transfer of SME assets effective February 19, 2010 for \$14,385,000.

At a special meeting of the Southern members on February 19, 2010, Southern approved the \$85 million Phase I construction financing for HGS and authorized Southern to enter into the documents associated with that transaction, which included transactions with SME.¹ (Ex. 1) The Notice of the Special Meeting stated that the transaction with SME consisted of: (1) the transfer to Southern "of all of SME's tangible and intangible personal property related to the development of Highwood Station," and (2) "lease to the Corporation of certain real property owned by SME (approximately 200 acres) on

¹ SME was organized in April 2008 by the four electric cooperative members of Southern who desired to continue with the development of HGS. SME officially filed as a Montana corporate on June 20, 2008, pursuant to the Montana Rural Electric and Telephone Cooperative Act. (SME 2010 Audit Report, p. 9, n.1)

which Highwood Station is to be developed.” (*Id.*, pp. 1-2) Specifically, the Southern members authorized “the Corporation’s acceptance of all or substantially all of SME’s tangible and intangible personal property related to the development of Highwood Station for the approximate value of \$14,385,000.” (*Id.*, p. 2, ¶6)

Although SME sold the HGS assets to Southern, Southern did not pay cash to SME for the assets. The transaction was effectuated by a bookkeeping transfer of the HGS assets and related liabilities from SME to Southern. *See infra*, pp. 4-5.

SME gave public notice of proposed disposition of substantially all of its assets pursuant to Montana Code Section 35-18-317. The Montana Code does not require the use of any particular valuation method or appraisal standards; the appraiser need only be free from any association with the buyer or seller. MC §35-18-317(3)(a). That Notice identified the personal property as “SME’s full interest in and to any plans, permits and engineering or other work related thereto; together with all of SME’s right, title and interest in and to all structures, improvements, and fixtures” on the real property, excluding fee title to the real property. (SME Public Notice, p. 1; Ex. 2) The SME Public Notice also disclosed that SME would lease to Southern, “for a term of more than twenty years,” a parcel of land, which was approximately 200 acres for the HGS facility. (*Id.*; SME 2010 Audit Report, p. 9, n. 1) The lease amount was \$40,000 per month and Southern paid SME \$240,000 in 2010 until Southern acquired the land from SME for \$400,000. (SME 2010 Audit Report, p. 9, n. 1) The purchase price was based on the average of three independent fair market value appraisals. (SME 2010 Audit Report, p. 19, n. 11)

According to Montana Code Section 35-18-317, when all or substantially all of the assets of a cooperative are to be sold, three appraisals of the assets must be obtained.² SME’s notice of the

² Section 35-18-317 provides: “**Disposition or encumbrance of property.** (1) Except as provided in subsection (2), a cooperative may not sell, mortgage, lease, or otherwise dispose of or encumber all or any substantial portion of its property unless such sale, mortgage, lease, or other disposition or encumbrance is authorized at a duly held meeting of members thereof by the affirmative vote of not less than two-third of all the members of the cooperative and unless the notice of such proposed sale, mortgage, lease, or other disposition or encumbrance shall have been contained in the

proposed distribution attached three documents purporting to appraise the assets to be transferred. The purpose of this appraisal requirement is to protect the members of the selling cooperative, SME in this case. There is no similar appraisal requirement when a cooperative is acquiring assets.

First, the SME notice attached a Valuation Assessment of HGS by Thomas, Dean & Hoskins, Inc., engineering consultants in Great Falls, dated January 15, 2010. TDH was retained by SME to assess the value of site improvements. TDH did not consider or assess any value for the real property and did not address the “resale value” of the site improvements. (TDH Report, p. 1; Ex. 3) TDH had previously been retained to assist Stanley Consultants, Inc. on the HGS project during the construction phase and a portion of the design phase. (TDH Report, p. 2) TD&H completed progress reports for the underground utility lines and related construction. (*Id.*, p. 1) TD&H was not independent with respect to SME or HGS and TD&H did not use any generally accepted professional appraisal standards to assess the value.

TD&H determined a total valuation for the “to-date site improvements” on the property to be \$6,420,068. (TDH Report, p. 1) TD&H reported that this assessment is “a monetary value of the site improvements and related engineering management effort necessary to get the project to its current state.” (*Id.*, p.2) TD&H qualified its valuation assessment by stating that its assessment “does not consider . . . the applicability of the site improvements to future design requirements of this project.” (TDH Report, p. 9) TD&H stated that “[n]o adjustment consideration was given to items such as . . . the applicability of the site improvements to future design requirements of this project (related to the potential change from a coal-fired plant to a gas-fired combined cycle plant).” (TDH Report, p. 8) TD&H’s valuation assessment did not address the fact that the HGS design plans had shifted from a coal-fired plant to a natural gas fired plant.

notice of the meeting. . . . (3) Before a meeting is held to vote on authorization of disposition of cooperative property, the board of trustees shall: (a) have the property appraised by three appraisers chosen by the board and not associated with the cooperative or a proposed buyer of the cooperative property. . . .” (Subsection (2) permits the cooperative to mortgage property to secure financing from a United States agency.)

Second, the Notice attached an Appraisal of Property, Certain Improvements at the Highwood Generating Plant Site as of January 15, 2010, by E3 Consulting, LLC. E3's appraisal was a "valuation study," the purpose of which was "to develop an opinion of the market value of the improvements in conjunction with a proposed transaction." (Jan. 18, 2010 Letter from E3 to T. Gregori; Ex. 4) E3 opined that the market value of the site improvements as of January 15, 2010 was \$5,925,000. (*Id.*; E3 Report, p. 6)

E3 applied the appropriate Uniform Standards of Professional Appraisal Practice, or USPAP, and E3 was independent. (E3 Report, p. 1) The facilities or site improvements valued consisted of the cooling tower pad, underground piping, solid waste landfill, road improvements, fencing and electric service.

Third, Worley Parsons provided a Site Improvements Valuation Assessment that was attached to the SME public notice. Worley Parsons concluded that the cost estimate was \$6,682,051. (Worley Parsons Report, p. 3; Ex. 5) Worley Parsons did not state that it was applying professional appraisal standards.

At a meeting on February 19, 2010, the Southern Board approved the acquisition of substantially all of SME's assets for the book value recorded by SME of \$14,385,000. (Ex. 6) There is no evidence that the Southern Board considered the following: (1) the appraised value of the project assets based on the reports attached to SME's Notice; (2) obtaining its own independent appraisal of the assets it acquired for \$14,385,000; (3) any detailed analysis of the costs and payables on SME's books that Southern assumed; or (4) why Southern agreed effectively to pay \$14,385,000 for assets valued at \$5,925,000. The April 16, 2010 power point presentation for the Southern Board prepared by Tim Gregori that summarizes the asset transfer and HGS financing transaction also does not address these issues. (Ex. 7)

Randy Boysun stated that an appraisal by Southern was deemed not necessary in February 2010 because the asset impairment analysis in 2009 had been performed relatively recently to determine the current

value of the HGS assets after the project officially changed from a coal-fired plant to a natural gas-fired plant. Thus, he concluded that the book value in February 2010 was sufficiently close to the fair market value.

The fees for the three valuation reports were accrued, along with other HGS project costs, and were included in the costs paid at closing of the financing in February 2010.

This related party transaction was disclosed in Southern's financial statements and in SME's financial statements.³

1. The Land

Southern originally acquired options to purchase the land for HGS for nominal amounts and later transferred those option rights to SME when SME was created. The options covered land sufficient to encompass the footprint for a coal-fired plant. SME exercised the options and acquired the land in 2008, using interim financing guaranteed by the four SME members. That interim financing was repaid out of the construction loan proceeds in February 2010, but SME retained ownership of the land at that time.

The acreage and footprint needed for HGS was substantially reduced when the plant changed to a gas-fired plant. At the closing of the Prudential financing, the parties intended to transfer the 200 acres necessary for the HGS gas-fired plant to Southern, although it took time to prepare the documentation and to pay off a lien to accomplish that transfer. In August 2010, SME sold the 200 acres for HGS to Southern for \$400,000. (Ex. 8) Until the sale was accomplished,

³ "Related parties" include "[a]ffiliates of the enterprise" and "other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own interests." Statement of Financial Accounting Standards No. 57 ("SFAS 57"), App. B, ¶24(f). "Transactions between related parties commonly occur in the normal course of business." SFAS 57, ¶1. Financial statements "shall include disclosures of material related party transactions. . . ." SFAF 57, ¶2.

Southern paid SME \$40,000 per month in rent for the land, for a total of \$240,000 in rent in 2010. (Ex. 9) In February 2011, SME approached the original landowner and proposed to sell 160 acres of the remaining land owned by SME for the same amount as the purchase price. SME continues to own the remainder of the land.

2. Closing and Use of Proceeds

Attached is a schedule reconciling the \$85 million of financing and use of proceeds. (Ex. 10) I found no evidence that any proceeds were diverted. The cost of issuing the bonds totaled \$3,885,496.08, as detailed in the attached schedule. SME did not receive any cash from the closing. Instead, assets and liabilities on SME's books totaling \$15,147,567.72 were transferred to Southern's financial records and then Southern paid off the lines of credit that SME had previously incurred at First Community Bank, Basin State Bank and Stockman Bank totaling \$6,865,123. Other disbursements at closing were for other project costs incurred including for equipment and engineering. The total cash disbursed for project costs was \$14,499,028. (*Id.*)

After deducting the issuance costs and project costs from the \$85 million, the net proceeds totaled \$66,615,475.85, which the trustee for the debt held in trust. The trustee set aside a capitalized interest fund of \$4,999,909.77 and a fund for interest during construction of \$5,043,750.00. The remainder, \$56,571,816.08, was the construction fund, which was drawn down upon after sworn affidavits, legal opinions and other documents supporting disbursement requests were submitted to the trustee, and after the trustee reviewed and approved the disbursements. Based on documentation obtained from Carrie Boysun, the process for preparing and reviewing draw requests included the following steps: (1) Boysun prepared a spreadsheet of monthly bills to be paid; (2) Boysun prepared the Company Request for Withdrawal, the Officer's Certificate, Bondable Additions Certificate, and Officer's Certificate as to Title Evidence and submitted them to attorneys Alan Bryan of Crowley Fleck PLLP in Billings and Cindy Upchurch of Sutherland Asbill & Brennan LLP in Atlanta for review; (3) Boysun responded to any requests from the attorneys for information or to edit the documents; (4) Boysun submitted final draw documents to Gregori

for his review and approval; (5) Boysun sent Bondable Additions Certificate to Kevin Cavanaugh of Stanley Consultants for review and approval; (6) Boysun sent executed documents with the withdrawal request summary to attorney Alan Bryan, who prepared an Attorney's Opinion; (7) after receiving the Attorney's Opinion, Boysun emailed all executed documents to the trustee at US Bank, copying Gregori, Cavanaugh, and Southern's president and secretary/treasurer; (8) US Bank executed the wire transfer as requested; and (9) Boysun mailed all original documents to US Bank; Bryan sent his original Attorney's Opinion separately to US Bank.

Because construction costs exceeded the initial budget and thus exceeded the construction fund balance of \$56,571,816, not all construction costs were approved and paid as of the bankruptcy filing. The construction fund was used to pay construction vendors pursuant to the process set forth in the financing documents.

By September 2011, Southern and Prudential knew that construction costs had exceeded the budget and \$56 million construction fund. The parties were working to obtain the second phase of financing which would be used to pay off the outstanding construction costs and to complete the next phase of the project. As of the bankruptcy filing, the Southern Board had discussed and approved the new limit in borrowing for the second phase. (Ex. 11)

B. Actions alleged to be without proper Board authority and/or in violation of the by-laws

1. Failure to pay Bonneville Power Association power bills.

In July 2011, Southern did not pay Bonneville Power Association's ("BPA") power bill issued in June. Beginning in April 2011, when Southern's obligation to purchase additional power from PPL arose, Southern began to experience significant cash flow problems. Southern anticipated the cash flow issues in 2010 and early 2011 and attempted to address the issue by increasing rates, increasing the member deposit accounts, and seeking financing. (*See, e.g.*, Dec. 2010 Board Minutes, p. 2 (4.5% rate increase effective with January invoices/December usage),

Ex. 12; Apr. 2011 Board Minutes, p. 2 (4.5% rate increase approved), Ex. 13; June 2011 Board Minutes, pp. 3-4 (4.2% rate increase approved due to ECP customer contract terminations as of June 30, 2011), Ex. 14.) Gregori worked with a daily cash flow schedule prepared by accountant Carrie Boysun and directed Boysun regarding which bills to pay and when.

The Board did not review and approve in advance the timing of the payment of the power bills. Nor is there any evidence that Gregori raised any issues at any Board meeting regarding not paying the BPA power bill in June 2011. From August to September 2011, Gregori directed five separate payments to BPA as partial payments for outstanding bills. (Ex. 15)

In a June 16, 2009 confirmation, PPL prices were set at \$50.70 MWh/hr, starting on April 1, 2011 and continuing to September 20, 2012. (Ex. 16) After BPA had announced in 2002 that it would no longer be able to deliver power in 2011 after Mid-Columbia came online, Southern had committed to alternative power supply by entering into a binding contract with PPL on June 16, 2009. Southern's Board repeatedly was concerned about ensuring an adequate power supply to meet the cooperatives' needs.

It turns out that Southern had contracted for more power than it needed in the spring of 2011 and that the terms were such that PPL interpreted them as a take and pay basis. In addition, when Southern contracted for the 185 MWhs, it appears that Gregori may not have taken into account the three blocks of power in prior contracts as reflected in the confirmations of September 24, 2004, August 2, 2005, and March 15, 2007, which were asserted to cover the load of Great Falls.

In the spring of 2011, Gregori, anticipating his cash flow needs, approached PPL, which rejected his attempts to relieve Southern of its obligations to purchase power from PPL. Gregori therefore entered into an April 27, 2011 agreement with PPL with to eliminate the three blocks of prior power purchases through 2011, which cost Southern \$3,768,000, to be paid in 48 monthly installments. (See discussion at

Section C.2, *infra*) Gregori presented the April 27, 2011 contract to the Board. (Ex. 17)

Gregori indicated in an interview that when faced with limited cash to pay the power bills, he considered that the BPA contract had late payment terms affording a customer the right to make late payments and he intended to spread the payments out over time. Gregori, however, did not inform BPA about Southern's cash flow crisis or intent to manage the BPA payments. Nor is there any evidence that Gregori discussed the late BPA payments with the Board. The Board was provided with detailed documents evidencing the cash flows and late payments. At the September Board meeting, the trustees were provided with the July 2011 general ledger and July 2011 check register detail that disclose the power bills received and amounts paid. (Ex. 18) There is no evidence of any attempt to ensure that the Board understood the cash flow issues or to point out the information regarding the power bills disclosed in those documents. Prior to the bankruptcy filing, BPA did not raise any issues with Southern's late and partial payments other than to charge a late fee, according to Carrie Boysun.

In July and August 2011, Gregori directed that PPL be paid in full for the June and July power bills. The remaining PPL bills, however, were only partially paid in September and October 2011. (Ex. 19)

2. Failure to pay contractors at Highwood Generation Station.

In February 2010, the Phase I construction financing issued by Prudential in the total amount of \$85 million closed. The attached schedule discloses the use of the loan proceeds. (Ex. 10) No cash was paid to SME. After payment of items at closing, the net proceeds available were approximately \$66 million, of which \$10 million was set aside for interest reserves to pay interest to Prudential. The trustee therefore held \$56 million for construction costs based upon the initial construction budget prepared with Southern's outside engineering experts.

Each month, Southern prepared a draw request that was certified by Gregori, reviewed by others and supported with invoices and documents indicating what budgeted expenses were to be paid with the drawn funds. (*E.g.*, Ex. 20) The draw requests were reviewed and approved by counsel, the title insurance company and the trustee. (*See supra*, p. 6.) The attached schedule demonstrates how the drawn funds were applied to budgeted construction expenses. (Ex. 21)

The HGS construction project exceeded the initial budget for Phase I and additional construction expenses of approximately \$5.5 million were incurred beyond the original \$56 million budget. (Ex. 22) The changed scope of the construction project, largely resulting from zoning issues, led to the additional costs. Prudential was informed about the construction costs and budget variances. The engineer, Kevin Cavanaugh, provided detailed reports to SME regarding the construction progress, scope changes and budget variances. The Southern Board minutes reflect that Cavanaugh and Gregori gave written and oral reports on the project status.

Although cash is fungible, I found no evidence that the Prudential construction draws were diverted to pay PPL power bills. The unpaid construction costs exceed the budgeted and construction costs that supported the draw requests and were in fact paid. The unpaid construction costs began accruing in July 2011. A few relatively smaller bills received in the summer and early fall of 2011 were paid, but the majority of construction bills incurred during that time period were not paid, including the invoices issued by the general contractor Corval and The Energy Corporation, which have filed mechanics liens.

At the December 2010 Board meeting, the HGS plant was anticipated to be operational by June or July 2011, and the Board approved the retention of Corval to complete the construction at that time. (Dec. 2010 Board Minutes, p. 2, Ex. 12)

The additional scope and construction status, including the rezoning changes, were reported to the Board by Cavanaugh and Gregori. In anticipation of the change in scope and budget variances, Southern discussed the status with Prudential and sought interim or

bridge financing while Phase II construction financing was being addressed and implemented. The Board approved the increase in debt limit from \$150 million to \$300 million in anticipation of Phase II financing. (June 28, 2011 Board Minutes, pp. 1-2, Ex. 14) Southern prepared and provided various projections and other financial information to Prudential in the fall of 2011 in an effort to secure interim financing to pay the outstanding invoices.

3. Contract with Energy West (September 2011)

In September 2011, Gregori executed a contract to buy natural gas from Energy West. Gregori stated in an interview that the purpose of that contract was to acquire natural gas necessary for the commissioning of HGS, which required gas to operate the plant to conduct various tests. For instance, at the September 2011 Board meeting, Cavanaugh reported on the HGS project status and the initial testing results. The Southern Board approved the Energy West contract at the May 2011 meeting, after the SME Board had discussed the purpose in more detail in their meeting regarding the HGS project shortly before the Southern Board meeting. (*See* May 2011 Board Minutes, p. 3, Ex. 23)

4. Contract with Northwestern Energy for Firm Transmission (December 2010; effective date of June 2011)

According to Gregori, the purpose of the Northwestern Energy transmission contract was to ensure firm transmission to the HGS plant, which was required in order to complete commissioning and make the plant operational. Also according to Gregori, Southern was required to demonstrate firm transmission before the commissioning process could occur. At the December 2010 Board meeting, Cavanaugh reported that the HGS plant was expected to go online in June or July 2011. (Dec. 2010 Board Minutes, p. 2, Ex. 12) The Northwestern Energy transmission commitment was discussed at the November 2010 Board meeting. (Nov. 2010 Board Minutes, Ex. 24)

C. PPL Contract Issues.

1. 2007 Term Sheet.

On September 17, 2004, Gregori advised the Southern Board of the details of a proposed contract for power purchase to provide a 5 MW block of power for the City of Great Falls. The Board approved a Power Purchase and Sales Agreement between Southern and PPL Montana, LLC, which provides the generic terms for any future specific agreement to purchase specific amounts of power. (Sept. 17, 2004 Board Minutes, Ex. 25; PPL Agreement, Ex. 26)

Southern, which was formed in 2003, initially obtained power from BPA (approximately 80%) and WAPA (approximately 20%). Pursuant to its contract, BPA recalled its power rights and declared that beginning in 2008, it was reducing the power supplied to Southern and ending all power supply to Southern by 2011. Accordingly, Southern faced a 50 mw decline in power supply from BPA beginning in 2008. By 2011, without any power supply from BPA, Southern projected a 160 mw shortfall. In about December 2005, Southern estimated that its 2011 load would be approximately 180 mw. Moreover, WAPA also had the right not to supply Southern, exposing Southern to further potential power needs. Despite efforts by Southern, including working with Montana's senators, Southern was unable to convince BPA to reverse the decision to recall the power supply previously committed to Southern for 2008 and beyond.

In addition, Southern was faced with requests from the City of Great Falls to increase the power supply for the City's customers and anticipated future customers.

On September 24, 2004, Gregori executed a Confirmation Agreement to purchase 5 mwh/hour from PPL for the period October 1, 2004 to December 31, 2008, at the price of \$41.70/MWh. (PPL Confirmation, 9/24/04, Ex. 27) Gregori had reported to the Board that this power was necessary to fulfill demand from the City of Great Falls and "Great Falls" is handwritten on the Confirmation Agreement.

On December 17, 2004, the Southern Board authorized Gregori to estimate the load requirements to meet the needs of the City of Great Falls and to begin discussing supply proposals from various suppliers to meet the City's demand. (Dec. 17, 2004 Board Minutes, p. 5, Ex. 28)

Included in the Board packet distributed at the January 21, 2005 Board meeting was an email dated December 28, 2004 from Randy Boysun to the CFC representative with whom Southern was corresponding about possible HGS project financing. (Ex. 29) Randy Boysun answered a number of questions raised by CFC, including questions about how much equity the members and the City of Great Falls had put into Southern. In response, Randy stated: "At this point the City's load forecast is 65 mwh, if different, power will be sold to another member." (12/28/04 Email from R. Boysun to Chris Comella, Ex. 29)

Also on December 28, 2004, Gregori sent Randy Boysun a memorandum providing additional detailed information to answer Comella's questions, including the question regarding power needs and the City of Great Falls' load forecast. (Ex. 30) Gregori stated that the existing City load forecast was 40 mwh and that load forecast for the remaining Southern members was 185 mwh, for a total of 225 mwh. Gregori noted that the City was working on a revised load forecast, and that R.W. Beck's draft suggested a total load forecast of 85 to 100 mwh for the City's metropolitan area. (12/28/04 Memorandum from Gregori to R. Boysun, p. 1, Ex. 30) Gregori further stated that Southern needed at least 25 mwh more, but the City was considering the extent to which it would include power needs in the metropolitan area and noted that therefore the total necessary mwh might be greater. (*Id.* at p. 2)

At the May 20, 2005 Board meeting, Gregori reported on the negotiations with PPL for additional power to supply the City of Great Falls' needs. Included in the Board packet was a May 9, 2005 Memorandum from Gregori to PPL attaching detailed information regarding Southern's and the City of Great Falls' anticipated future power needs. (Ex. 31) The City projected a total of 12 mwh for September 2005 to June 2006 and 16 mwh for July 2006 to September 2011. (*Id.*)

On June 17, 2005, Southern entered into another contract with PPL for a block of power to be supplied to the City of Great Falls, which Gregori reported to the Board at the June 17 Board meeting. As a result of this purchase, Gregori reported that the City would be using approximately 17 MW. (June 17, 2005 Board Minutes, Ex. 32)

In a July 22, 2005 memorandum to the Board, the City's then-manager, John Lawton, reported on how the City was working to increase its load and to meet its obligation to finance a portion of the HGS plant. (Ex. 33) The City reported it was seeking to supply power to small businesses and residential customers, and that based on the second block of power just purchased from PPL, the City was executing contracts with large industrial customers for stable rates through 2011. The City reported that by July 2006 it was expecting to serve approximately 15 mwh of load. (7/22/05 Memorandum from J. Lawton to Board, p. 2, Ex. 33) Attached is the Revised Confirmation dated August 3, 2005, which confirms the agreement to purchase 6 mwh/hour on-peak and 5 mwh/hour off-peak from 9/1/05 to 6/30/06, and 10 mwh/hour on-peak and 8 mwh/hour off-peak from 7/1/06 to 9/30/11 at \$44.15mwh. (Ex. 34) The 10 mwh for July 2006 plus the existing 5 mwh confirmation through 2008 totaled the 15 mwh load estimated by the City commencing in July 2006.

At the Southern Board meeting on October 21, 2005, Gregori reported on recent discussions with PPL regarding anticipated power needs when the 5 mwh agreement ended on December 31, 2008. Gregori stated that PPL had declined to submit an RFP for power purchases commencing in 2008. (10/21/05 Southern Board Minutes, p. 2, Ex. 35) Gregori stated that any RFP was premature until the time period for any system needs requirements were fully understood and that the members had to be careful about simultaneous and overlapping commitments to purchase power. (*Id.*)

At the December 15, 2005 Board meeting, John Lawton, the City of Great Falls' manager reported that the City had retained R.W. Beck, which reported that the City benefited from engaging in wholesale power purchases as opposed to purchasing power from Northwestern

Energy. The R.W. Beck study was distributed to the Board. Lawton further reported that the City was currently purchasing 16 mwh and planned to purchase an additional 5 mwh from Southern by June 2006. (Dec. 15, 2005 Board Minutes, p. 4, Ex. 36)

On April 21, 2006, the City of Great Falls Manager reported to the Southern Board that “We continue to see substantial interest in power supply from large customers. We were recently approached by a potential customer of 25 mw of load. . . . We are anxious to expand our supply portfolio to accommodate other large customers.” (Ex. 37)

On May 19, 2006, an ECI representative presented the results of bids submitted by PPL and Powerex effective July 2008 through February 2011. PPL bid \$54.80 per mwh and Powerex bid \$60.66 per mwh. (May 19, 2006 Board Minutes, p. 2, Ex. 38; *see* June 9, 2006 PPL Firm Price Letter in May 19 Board packet, Ex. 39) The Board authorized management to continue negotiations with PPL to attempt to obtain the best possible rate for approval by the Board.

On June 9, 2006, PPL responded to the RFP issued on March 31, 2006. On June 16, 2006, Gregori reported to the Board the results of an RFP to PPL for bridge power. (June 16, 2006 Board Minutes, p. 3, Ex. 40) On July 28, 2006, Gregori reviewed the valuation of the proposals for 2007 to 2011 power submitted by ECI. The ECI analysis indicated that PPL’s bid for power to meet the City of Great Falls’ requirements represented the most desirable option. (June 22, 2006 Letter from ECI, Ex. 41) ECI recommended that Southern pursue the purchase of power from PPL for short-term supply and develop HGS for long-term supply because the estimated cost of HGS power was \$35.84/mwh, as opposed to \$54.80 from PPL and \$60.66 from Powerex. (*Id.*)

The City of Great Falls continued to report its anticipated energy requirements. In a memorandum to Gregori dated July 19, 2006, the City’s finance director stated that the “City currently has contracts in place serving in excess of 300 meters at an average load of 20 mwh. These customers are long-time stable businesses located within Great Falls. They include government operations of the City School District, Airport Authority, Housing Authority, and Montana Air National

Guard. Also include are local businesses such as Benefis Hospital, General Mills, Meadow Gold Dairy, FedEx and Montana Refinery. The intent is to review and extend these contracts to closely match the life of the plant financing. In addition, the City is currently in the process of wrapping up negotiations with select potential large customers to fill out its remaining portion of the 65 mw's of output from HGS." (Ex. 42) The City also noted that as a fallback, Southern had reserved transmission service to ship to Mid-Columbia so that excess power could be sold to customers in that area. (*Id.*)

After the market soured, in March 2009, Gregori signed a contract for PPL to buy back excess power it was forcing Southern to take. PPL paid 87% of market index for power on peak and 82% for off-peak power. (Ex. 43)

In the fall of 2008, the Board authorized an RFP process for Gregori to seek bids for power supply through 2012 and 2013. (Ex. 44) ECI was retained as an expert consultant to review the bids and advise Southern. (*Id.*) The Board received monthly reports regarding the RFP process and regarding PPL rates and obligations. (*E.g.*, Ex. 45)

2. April 28, 2011 Amendment to PPL Power Purchase and Sale Confirmation Agreements. (Dated April 27, but signed April 28 by both parties)

In April 2011, Gregori executed an amendment to the PPL agreement to permit Southern not to take PPL power that it was otherwise obligated to purchase. The PPL amendment was discussed with and approved by the Board in a closed session at the April 22, 2011 Board meeting, along with a 4.5% rate increase. (April 2011 Board Minutes, pp. 2-3, Ex. 13) (The session was closed because reporters from the Billings Gazette had begun attending Southern Board meetings by 2011 and the Board determined that public disclosure of power price information would have had an adverse impact on Southern and its ability to demand competitive prices.)

Prior to April 2011, Gregori approached PPL about renegotiating the agreement to take additional power commencing in April 2011.

According to Gregori, the original commitment was based upon the 2007 load forecasts and representations by the City of Great Falls that its load requirements would increase.

PPL proposed that Southern's payments on PPL contracts from April 25, 2011 to June 30, 2011 (totaling \$3,768,000) be deferred until January 2012. Southern would still be required to pay on the contracts from July 1, 2011 to September 30, 2011, but those contract requirements would end by September 30, 2011. The deferred payments for May and June would commence in January 2012 with monthly payments of \$78,500 per month until the balance was paid off. In order to secure this relief, PPL required a \$2 million letter of credit, which would be reduced as PPL received the \$78,500 monthly payments by those payment amounts. (Ex. 13) Gregori presented this PPL proposal at the April 22, 2011 Board meeting, and, at the same time, he also presented a cash flow projection indicating that Southern's cash balance would zero out by June 2011 without a 4.5% rate increase. (Ex. 46)

3. Retention of and payment to lawyers, including Ken Reich (Wolf Block) and Jon Doak

Ken Reich performed legal services for Southern relating to HGS, including legal services concerning various regulatory, environmental and permitting issues. The total legal fees paid to Reich from approximately April 2005 to April 30, 2008 (after which YVEC was not responsible for such legal costs associated with HGS), totaled \$3,872,912. I found no evidence in the Board minutes of any motion or resolution to approve the retention of Reich or his firm. Management did regularly inform the Board about Reich's retention and the nature of the legal services performed. Board packets included references to Reich and documents prepared by him from time to time. In addition, the monthly financial reports, which the Board routinely unanimously voted to approve, contained detailed disclosures of the dollar amounts paid to Reich's law firm. The evidence indicates the Board knew of the general nature of Reich's legal services and the amounts invoiced and paid for those services and ratified those actions by Southern.

At the second annual meeting of the Southern members on April 22, 2005, Southern's auditor, Rick Matusiak, recommended that Southern begin documenting the cost of participation in the development, construction and operation stages of Highwood Station to comply with RUS requirements. (April 2005 Board Minutes, Ex. 47) Accordingly, the Board packets after that date include information concerning HGS costs, including legal fees. Also at that annual meeting, Reich was introduced as the attorney retained by Southern "to handle matters associated with state and federal EIS [environmental impact study] requirements," and he made a presentation to the members regarding Southern's obligation to conduct an EIS and acquire permits. (*Id.*)

The Board packets disclose that Reich worked with Bison Engineering, Stanley Consultants and other firms retained by Southern in the development phase of HGS. (E.g., Bison Engineering Report, March 2006, Ex. 48) Reich also attended meetings with RUS. (Apr. 26, 2006 RUS Update Agenda, Ex. 49) The Board packets included Reich's August 11, 2006 Privileged Memorandum to Gregori regarding EIS Status and Process. (Ex. 50) Further, Reich was involved in zoning issues and the environmental litigation concerning the proposed coal-fired HGS project.

Reich also occasionally attended Board meetings and reported directly to the Board. (*E.g.*, Dec. 22, 2006 Meeting Agenda; Dec. 20, 2007 Meeting Agenda; Ex. 23; Jan. 18, 2008 Meeting Agenda; Feb. 22, 2008 Meeting Agenda; Apr. 17, 2008 Meeting Agenda; *see also* Mar. 21, 2008 Annual Meeting Agenda, Ex. 51)

The Board did not always formally vote on motions to retain legal counsel for different purposes and implicitly ratified such retention. (*E.g.*, Oct. 21, 2005 Meeting Minutes, p. 1, regarding authorization of legal expenses payable to the law firm of Luxon and Murfitt for the services of Candace Payne; Ex. 52; *compare* Feb. 22, 2008 Meeting Minutes, p. 6, formally approving Sutherland Asbill as counsel; Ex. 53). In addition, at annual meetings of the members, the members formally voted to ratify all legal action taken in the prior year by Southern. (*E.g.*, Mar. 16, 2007, Annual Meeting Minutes, p. 4; Ex. 54)

The HGS project cost reports provided to the Board reflect that through December 2006, Southern had paid Reich \$1,307,313.90. By September 30, 2007, the total legal fees paid to Reich grew to \$2,557,920, and by December 31, 2007, the total was \$3,241,865. (Ex. 55) The legal fees in 2007 were close to budget (\$1,296 over budget through October 2007). At the June 2, 2008 special Board meeting, Trustee David Kelsey for YVEC stated that he would need to see all legal bills broken down by hours and rate and project cost. (June 2, 2008 Minutes, p. 2, Ex. 56)

4. Other Related Party Transactions

Southern engaged in a number of related party transactions with SME and IESS. Gregori served as manager for all three parties. The Board knew about Gregori's role with respect to SME and reviewed and approved the use of Southern resources by SME, including the costs charged to SME for that use. The Board also approved of the transactions with IESS. IESS also independently paid Southern employees, including Carrie Boysun, for example, to perform certain bookkeeping services. After the bankruptcy was filed, Southern employees ceased performing any additional services for IESS.

5. The assessment of the Toshiba contract liability from December 2008 to May 2009.

As part of the coal-fired plant plans, Southern contracted to purchase a steam turbine generator from Toshiba. The Toshiba contract was originally executed prior to the April 2008 resolution. In November 2006, the Southern Board approved a resolution authorizing negotiations for a steam turbine generator. (Nov. 17, 2006 Minutes, Ex. 57) The first installment in the amount of \$1,291,500 was paid December 29, 2006. (Ex. 58)

In March 2007, the Board adopted a resolution to suspend the contract, which had the consequence of granting Toshiba rights to terminate the contract and demand termination payments of \$2.5

million if Southern did not proceed with the purchase by March 2008. (Mar. 15, 2007 Minutes, Ex. 59)

In May 2008, Toshiba wrote to Southern demanding the penalty payments. Southern attempted to renegotiate, unsuccessfully, and paid the penalties previously agreed upon. Southern then assessed all cooperative members in their monthly power bills based upon their respective load share ratios. (Ex. 60) On November 24, 2008, the Southern Board approved payment to Toshiba of one-half of the contract termination fee of \$1,291,500 by December 15, 2008, and also approved assessment of the members for their share of that fee. (Nov. 24, 2008 Minutes, Ex. 61) YVEC did not pay the assessed amount (although it voted to make the contracts, terminate the contract it had approved the payment at the November 24, 2008 board meeting). At a December 19, 2008 Board meeting, the Board approved, over YVEC's objection, the transfer of YVEC's portion of the termination payment (\$552,762) to YVEC's power bill. YVEC contended that those assessments were for HGS costs incurred after May 1, 2008, contrary to the April 2008 resolution. The second termination payment was due May 31, 2009. YVEC also declined to pay any amount of its portion of the second termination payment, which totaled \$552,762. (Ex. 62)

Attached is a schedule reflecting the dates of payments to Toshiba and the sources of funds used to pay Toshiba. (Ex. 63) YVEC's initial share of \$552,762 was paid out of Southern's general funds, and on April 30, 2009, Southern paid YVEC's share of \$276,381. Southern paid the final amount owed by YVEC by using funds from CFC Commercial Paper Withdrawal.

The liability for the Toshiba penalty payments was fixed prior to May 1, 2008. Toshiba did not exercise its option to terminate and make the demand for payment until later in May 2008, but according to Financial Accounting Standard Board Statement Number 5, a loss contingency should have been accrued prior to May 1, 2008, because it was probable that such a payment would have to be made and the amount was reasonably ascertainable. Thus, Southern's assessment to YVEC for this amount appears to have been proper because the facts and circumstances fixing that liability occurred prior to May 1, 2008.

6. Allocation of Expenses Relating to HGS Project.

Southern allocated HGS expenses to the HGS project and attempted to exclude HGS costs from the rates charged to the nonparticipating member YVEC. Attached is a schedule reflecting the assumptions used to allocate various overhead and business expenses to the HGS project accounting. (Ex. 64)

Also attached are examples of timesheets used by Carrie Boysun and Troy Dahlgren to track time spent on Southern matters and time spent on HGS-specific matters. (Ex. 65) Overhead expenses were allocated to the HGS project based on the ratio of time spent on HGS matters. Southern's independent auditors reviewed the allocation process as part of their annual audits and did not identify any discrepancies.

7. First Interstate Bank (FIB) Lines of Credit

Southern obtained a \$1.25 million line of credit from FIB in June 2008. On August 8, 2008, Southern received a waiver letter from FIB, which allowed Southern to transfer funds from the line of credit to SME. (Ex. 66) Accordingly, on August 26, 2008, the \$1.25 million advance on the line of credit was received by Southern from FIB and then immediately transferred to SME.

SME used the \$1.25 million to purchase a portion of the land from Urquhart Family for the HGS station. (The remaining land was acquired pursuant to a loan between SME and the Urquhart Family that was guaranteed and repaid by the SME members.)

To repay the FIB line of credit, SME assessed its members monthly assessments assuming that the FIB line would be repaid over 12 months with a 6% interest rate. The participating Southern members received power bills each with reflecting this additional assessment and Southern agreed to collect these assessments and pay FIB directly on behalf of the SME members. YVEC was not assessed

these amounts. The monthly power bill had a line item entitled “Monthly payment on Land (Loan and Line of Credit).” (Ex. 67)

This intended practice was carried out for the first three loan payments to First Interstate Bank in the fall of 2008. After Southern passed on those first three payments to FIB, Southern stopped paying FIB but continued to collect the monthly payments from the HGS-participating members for the remaining nine months through 2009 because Southern needed the cash flow. All SME members were billed and paid their monthly assessments to Southern. Southern used the cash flow for general operating expenses. FIB granted Southern multiple extensions of the maturity date of the line of credit and Southern eventually paid the FIB line down to a zero balance on March 31, 2010. (Ex. 68)

After March 31, 2010, Southern needed the cash flow from the line of credit and borrowed again on the line of credit to provide cash flow between the payments of power bills and the receipt of payments from all Southern members. For example, the PPL power bills were always due around the 20th of each month, but Southern did not receive all member payments by that date. (Ex. 69) This line of credit eventually matured and then Southern obtained an additional \$1.25 million line of credit from FIB in May 2011, which was unsecured and guaranteed by Beartooth, Fergus, Mid-Yellowstone and Tongue River. This line of credit was fully drawn and not repaid as of the bankruptcy filing. (Ex. 70)