

Due Diligence Report to BEC Board, October 29, 2013

Due Diligence meeting, October 24. Present: Roxie Melton, David Peterson, Jack Schutte, Judith Gregory, Frank Willett, and Arleen Boyd. BEC Board members Pat Hoffman, Dick Nolan, Dan Dutton. Staff: Richard Peck and Bob Walker.

The committee reviewed a worksheet prepared by Frank Willett from the financial information documenting the Trustee's plan and the proposed contract for power with Morgan Stanley (the "Willett Worksheet"). Some of the information on the Willett Worksheet comes from sealed documents. The plan calls for Southern to pay approximately \$ 100 million in debt to the noteholders (Prudential and Modern Woodmen) and other secured creditors. The plan also shows significant operations costs for Southern, including three full time employees and costs for keeping HGS "operations ready" for Morgan Stanley to dispatch at will. If HGS is dispatched, then Southern will receive 90% any positive net margins. By retaining HGS the plan almost certainly will cause Southern to incur millions of dollars in operations costs for HGS, which we predict will exceed any potential revenue. In addition, it appears that the plan omits certain costs and expenses that Southern almost certainly will incur. However, because the Willett Worksheet uses protected information, there is some question whether it can be distributed or otherwise made public. Therefore, BEC has asked the trustee to allow distribution of the Willett Worksheet..

BEC, Fergus and Mid Yellowstone commissioned a plant engineer to visit HGS, to report on the cost of HGS operations and to examine potential costs and expenses required to keep it "operations ready." An initial draft report shows that keeping HGS operations ready may require substantial costs and investment. However, the engineer will not finish his final report until November.

The committee discussed requirements for funding current legal actions in Southern's bankruptcy. The Court approved the Trustee's Disclosure Statement, which means the next step is plan confirmation. To object to the plan and support our legal and factual arguments against plan confirmation, BEC needs to engage expert witnesses and consultants. The Committee believes that BEC should engage these witnesses and consultants in this quarter, rather than in the first quarter of 2014 or later. Earlier engagement will allow the experts to become familiar with the complex facts and legal theories of the case and to begin preparing their expert opinions for use not only in a future plan confirmation hearing but also in BEC's current adversary proceedings and any negotiations. **The committee encourages the board to increase funding by \$100, 000 for 2013** – an amount legal liaison Arleen Boyd described as necessary to allow decisions to be made by counsel and the co-op to support our position in the bankruptcy if payments need to be made in 2013.

Counsel for Beartooth, Martin Smith, joined the meeting telephonically.

Judge Kirscher vacated the deadlines related to plan confirmation, including the hearing scheduled for November 12. The Court instructed the parties to present a proposed plan confirmation schedule to the Court. Some parties have indicated that mediation may be indicated in this matter, and the Trustee requested input from all parties. BEC has not responded and, currently, there is no agreement to mediate. BEC will discuss its mediation position at October board meeting.

Liquidation Filing. The four Southern co-ops filed a plan to liquidate Southern under Chapter 11 of U.S. Bankruptcy Law. The plan will be posted on the BEC website upon the Court's approval of the related disclosure statement.

Motion to remove Southern's trustee. Fergus Electric Cooperative filed a motion to terminate the appointment of the Chapter 11 trustee. The motion asserts that the circumstances under which the Court appointed the Chapter 11 trustee have changed and there is no need for a Chapter 11 trustee. BEC will vote at October board meeting on submitting a joinder in support of this motion. **The due diligence committee recommends supporting** the motion to terminate the appointment. The Court will hear argument on the motion to terminate the appointment of the Chapter 11 trustee on November 12.

The Noteholders' Motion to Dismiss BEC's first adversary proceeding. The Court will hear the Noteholders' Motion to Dismiss BEC's first adversary proceeding on November 12. BEC has asserted that Southern and the Noteholders failed to follow Montana law when Southern pledge of the wholesale power contracts to the Noteholders as security for payment of Southern's promissory notes. BEC asserts that this renders void the pledge of those contracts. The Noteholders have requested the Court dismiss the claim for various reasons.

Four co-ops filed a second adversary proceeding asserting that the wholesale power contracts may not be assumed and that the wholesale power contracts are void for failure of consideration. The four cooperatives have jointly filed an adversary proceeding against the Chapter 11 trustee. The Chapter 11 trustee has answered and asserted counterclaims against the cooperatives. The counterclaims request the Court to make various finds and declarations. The cooperatives are preparing an appropriate response to the counterclaims. The Court has set a scheduling conference for December 12, 2013.

Bankruptcy 2004 Examination of Beartooth. On October 22 the Chapter 11 Trustee examined Arleen Boyd as representative for BEC. The six-hour examination included questions regarding BEC comparative shopping of power suppliers and conducting other investigative due diligence to ascertain potential options outside of Southern with better options for BEC than the Trustee's proposed reorganization under a power contract with Morgan Stanley. The trustee has not stated the reason for his questioning which repeatedly suggested that BEC did not understand the benefits of the reorganization plan. The Chapter 11 trustee produced numerous examination exhibits, at least one of which showed national electricity rates. That

exhibit appeared to support BEC's conclusion that, under the proposed plan, BEC's power costs will continue to be some of the highest in the country – among the top 2% of all electric utilities. .