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April 26, 2013

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Mayor Mike Winters
City of Great Falls
P.O. Box 5021
Great Falls, MT 59403-5021

Greg Doyon, City Manager
City of Great Falls
P.O. Box 5021
Great Falls, MT 59403-5012

Re: *The Southern Montana Bankruptcy Case
The City of Great Falls and ECP vs. Southern Montana
Proposed Settlement*

Dear Mayor Winters and Mr. Doyon:

I am writing to you in order to recommend that the City and ECP approve a potential settlement with the Trustee for Southern Montana. The terms of the settlement and our rationale are set forth below. There is no benefit to the City remaining a member of Southern Montana. There are only negatives. Accordingly, we recommend that the City and ECP accept and approve the proposed settlement.

I. Background.

Justice Jim Regnier contacted us recently about the possibility of a third mediation conference. Mr. Regnier contacted us at the request of the attorneys for Lee Freeman, the Chapter 11 Trustee for Southern Montana.

Our response to Justice Regnier's invitation was guarded. As you know, we have had two very disappointing mediation conferences with Southern Montana and Trustee Freeman. The Trustee sued the City and ECP for an amount in excess of \$60,000,000.00. The Trustee filed a counterclaim against the City of Great Falls and ECP asserting six causes of action, including:

Brent R. Cromley
Of Counsel

K. Kent Koolen
Of Counsel

FREDRIC D. MOULTON
(1912-1989)

W.S. MATHER
(1922-1998)

WM. H. BELLINGHAM
(1920-2002)

BERNARD E. LONGO
(1918-2011)

ADMITTED TO PRACTICE IN
WYOMING*
NORTH DAKOTA**
ARIZONA***
NEW YORK****

Count One: A Declaratory Judgment that the Wholesale Power Contract is valid and enforceable against both Great Falls and ECP through December 31, 2048. The Trustee seeks a Court Order that the Wholesale Power Contract requires Great Falls and ECP to purchase and receive all electric energy required by Great Falls and ECP customers through December 31, 2048; that Great Falls and ECP are required to take all measures necessary to avoid any further reduction in their load; that Great Falls and ECP have violated and breached the terms and conditions of the Wholesale Power Contract and the implied covenant of good faith and fair dealing and that as a result of these breaches, Southern is entitled to specific performance and damages including the recovery of stranded costs; that the City and ECP's breaches have been accompanied by bad faith, fraud, willful, wanton or fraudulent conduct; that the City owes a water credit to Southern Montana in the amount of \$1,186,061.83; and, that Great Falls is obligated to proceed with prosecution of its change application with the DNRC with respect to the Water Service Agreement. The Trustee also seeks a declaration from the Court that Section 1(D) of the Wholesale Power Contract (this is the provision that limits Southern's recourse against the City of Great Falls) is invalid and unenforceable.

Count 2: Specific Performance. The Trustee seeks a Court Order requiring the City of Great Falls and ECP to specifically perform their obligations under the Wholesale Power Contract.

Count 3: Injunctive Relief. The Trustee seeks an injunction to require the City of Great Falls and ECP to honor their contractual obligations under the Wholesale Power Contract. The Trustee also seeks an injunction to require Great Falls and ECP to take all measures necessary to avoid any further reduction in their load. The Trustee seeks an injunction requiring Great Falls and ECP to maintain the status quo of the contractual relationships between Great Falls/ECP and each and all of the existing ECP customers and take all measures necessary to avoid further reduction in their load.

Count 4: Breach of Contract including the implied covenant of good faith and fair dealing. The Trustee alleges that the City and ECP have wrongfully repudiated and violated their obligations owed to Southern under the Wholesale Power Contract and as such have materially breached the contract.

Count 5: Breach of Contract including the implied covenant of good faith and fair dealing - Water Services Agreement. The Trustee alleges that the City's refusal to perform its obligations under the Water Services Agreement has caused it to suffer damages.

Count 6: Breach of Contract including the implied covenant of good faith and fair dealing. This count relates to the Water Services Contract and alleges a breach of that contract.

The Trustee also seeks an award of prejudgment interest as well as an award of attorney fees and costs.

The two mediation conferences and our subsequent settlement negotiations were unsuccessful because the Trustee continued to demand an exorbitant settlement price which the City could not pay, even if it was so inclined.

When approached by Justice Regnier recently, we felt that there was little utility in another Mediation Conference. Justice Regnier suggested an alternative to a third formal Mediation Conference. He suggested that he develop a settlement number that he would take to the attorneys on each side and ask them to recommend it to their clients. The numbers proposed by Justice Regnier are as follows:

- a. The City and ECP would pay the sum of Two Million Five Hundred Thousand Dollars (\$2,500,000.00) to Southern Montana during this fiscal year after approval by the City Commission and approval of the United States Bankruptcy Court and the expiration of all appeal time.
- b. The City would pay the sum of seven hundred-fifty thousand dollars (\$750,000.00) to Southern Montana in the next fiscal year on or before December 31, 2013.

The total settlement figure proposed by Justice Regnier is three million two hundred and fifty thousand dollars (\$3,250,000.00) to be paid by the City and ECP to Southern Montana. Justice Regnier has confirmed that Trustee Freeman has accepted these settlement terms. Rephrased, the proposed settlement would involve immediate payment of the amount due on the Water Credit plus an additional \$2,063,939.00.

II. The Process.

If the City accepts Justice Regnier's proposal, it would be necessary for us to go through a significant process in order to conclude a settlement. That process would include the following:

- a. City and ECP Approvals. The City and ECP would need to publicly notice a meeting to consider approving the proposed settlement with Southern Montana. If the Settlement is approved then it would be necessary to execute a Settlement Agreement with the Trustee for Southern Montana. The proposed Settlement Agreement is attached.
- b. Settlement Agreement and Rule 9019 Motion. The settlement would also require Bankruptcy Court approval. The process of obtaining that approval involves filing a Motion with the Bankruptcy Court pursuant to Bankruptcy Rule 9019 for approval of the settlement terms. Typically, the Settlement Agreement would be attached to the Motion. Parties would

have 14 days to file written objections to the Rule 9019 Motion and the settlement. If no objections are filed, the Court can enter an Order approving the settlement. If Objections are filed, the Court would schedule a hearing within the next 30 days. At that Hearing, it would be incumbent upon both the Trustee and the City to present evidence as to why the settlement should be approved.

c. Summary of the Settlement Terms.

- i. The City and ECP would pay Two Million Five Hundred Thousand Dollars (\$2,500,000.00) to Southern Montana after the appeal time expires on the Court Order approving the Rule 9019 Motion to Approve the Settlement. The appeal time is 14 days. Payment would be made promptly (within a couple of days) of the 14 days expiring.
- ii. On or before December 31, 2013, the City and ECP would pay an additional Seven Hundred Fifty Thousand Dollars (\$750,000.00) to Southern Montana.
- iii. The Parties would mutually release each other of any and all claims. This would include Southern releasing and discharging the City and ECP, any of its past and present managers, directors, officers, agents, elected officials, employees, insurers, reinsurers, accountants, and attorneys, from any and all contracts, actions, claims, causes of action, demands or expenses unforeseen, including, without limitation, any claims arising out of, related to or which were or could have been made in the State Court Litigation, the Adversary Proceeding, or in the Bankruptcy Case. This release includes, but is not limited to, claims of violations of any state or federal statute, any federal or state common law doctrine, breach of contract, including but not limited to, claims under the WPC, negligence, actual fraud, negligent misrepresentation, tortious interference, bad faith, breach of the implied covenant of good faith and fair dealing, slander, libel, defamation, negligent or intentional infliction of emotional distress, all claims for water credits and water rights including, but not limited to, claims under the Water Services Agreement, and any other damages, demands, costs attorney's fees, or expenses of any kind.
- iv. Southern Montana's claims against the City and ECP with respect to the "water credit" would be settled and would be expressly released as part of the Release of all Claims.

Southern Montana would release any and all claims that it may have to any water or water rights from or through the City and ECP and the pending appeal for the Change Application for Water Rights will be withdrawn and dismissed with prejudice.

- v. Any and all contracts (including amendments and supplements) between the City and ECP and Southern Montana would be terminated, including but not limited to the Wholesale Power Contract dated October 2, 2007, the Water Services Agreement dated March 15, 2005, and any others. Parties would have to agree on termination dates.
- vi. The City and the ECP would withdraw from membership in Southern Montana.
- vii. The City and ECP would waive their right to receive any distribution on the Proofs of Claim that were filed in the Southern Montana Bankruptcy case.
- viii. On or about (an agreed upon date), the City and ECP would stop receiving energy through Southern Montana. It would be necessary to transition the City and ECP's remaining customers to another energy provider. We would request Southern's assistance in transitioning the remaining ECP customers to another energy provider.
- ix. The District Court case pending in Cascade County, *City of Great Falls and Electric City Power, Inc. v. Southern Montana Electric Generation and Transmission Cooperative, Inc., and SME Electric Generation and Transmission Cooperative, Inc.*, Cause No. CDV 11-0256, would be dismissed, with prejudice, upon the merits. Dismissal would also require the concurrence of SME Electric Generation and Transmission Cooperative, Inc., which is a defendant in that action.
- x. The pending bankruptcy adversary case captioned *The City of Great Falls, Montana and Electric City Power, Inc. vs. Southern Montana Electric Generation and Transmission Cooperative, Inc.*, Adversary No. 12-00035, would be dismissed, with prejudice, upon the merits.
- xi. The settlement shall not constitute an admission by any party. The Parties deny all allegations.

- xii. Each party would pay its own respective costs and attorney's fees.

III. Case Analysis

The Adversary Case is currently set for trial in February 2014. The trial is scheduled for the Federal Courthouse in Missoula, Montana. The Trustee projects that the trial will take approximately three weeks. Substantial work remains to be done in the adversary case prior to trial. The attorneys for the Trustee have advised us that they have approximately two dozen or more people that they intend to depose initially. There could be more. Thus far, we have identified 88 potential fact witnesses. We anticipate that it will be necessary to take the depositions of a majority of those witnesses.

We have only begun the process of identifying, analyzing, and producing relevant documents. The Trustee hired an independent company in order to establish an on-line data room to assist the Trustee with the same task. Informally, the Trustee has produced approximately 10 banker's boxes of documents for us. At this time, we cannot project how many documents are going to be involved. I can only tell you that the number of documents is going to be in the tens of thousands and probably will be in excess of 100,000.

The City is also going to incur substantial expert witness expenses. We've identified a potential expert witness to assist us with the litigation. His hourly fee is \$350.00. This case involves complex issues, voluminous documents, and numerous witnesses. We anticipate a three week adversary trial and potentially a three week confirmation hearing. Given those time frames, and the complexity of the case, we roughly estimate your expert witness fees at half a million dollars. They could, however, be substantially more. We are potentially going to need more than one expert witness.

We project that your attorney fees and costs (including expert witness fees) in connection with the Adversary action will exceed \$1,000,000.00. If there is an appeal, which is likely, the costs would increase. To put this in perspective, Yellowstone Valley Electric's attorney fees and costs were in excess of \$750,000.00, without a trial. In addition to the Bankruptcy Adversary litigation, the City is incurring attorney's fees and costs associated with the main Southern Montana Bankruptcy case. There is a one week valuation hearing scheduled for the end of July in Missoula. That Hearing will focus on determining the value of the Highwood Generating Station and the associated All Requirements Contracts. This hearing will also be utilized to determine whether or not the Secured Lender (the noteholders) are entitled to a "make-whole payment" under the terms of their Indenture. The Secured Lender claims that certain events can trigger a make-whole payment under the terms of their indenture. The make-whole payment may be as much as \$46,000,000.00.

We anticipate that the Bankruptcy Court will enter an opinion on the value of HGS and the All Requirements Contracts within 30-60 days after the conclusion of the Valuation Hearing. Once that opinion has been issued, the Trustee will amend his Disclosure Statement and Plan. Then a hearing on the Disclosure Statement will be scheduled and Creditors will be given an opportunity to review and object to the adequacy of the Disclosure Statement. The purpose of the Disclosure Statement is to provide Creditors with sufficient information to enable them to make an informed decision on the Trustee's Proposed Chapter 11 Plan of Reorganization. Typically, Creditors object to the Disclosure Statement after which the Debtor supplements or amends the Disclosure Statement to provide additional information. If the Debtor is successful, at some point the Court will approve the adequacy of the Disclosure Statement. Once that happens, the Disclosure Statement, the Trustee's Chapter 11 Plan, and a Ballot will be transmitted to all Creditors. Creditors will then have an opportunity to vote on the Plan. The Court will schedule a Confirmation Hearing to determine whether or not the Plan can be confirmed. The Trustee's attorneys have indicated that the Confirmation Hearing may take as long as three weeks. We anticipate that the Confirmation Hearing will not take place until late 2013 or sometime in 2014.

IV. Points to Consider.

1. The City joined Southern Montana in order to secure a cheaper, long term source of electric energy. That objective was not achieved. The City is currently paying above market electric rates. If the City remains a member of Southern Montana, we anticipate that it will pay electric rates that will be higher than the market rate for at least ten years, and possibly through 2048. We see no benefit to the City from continued membership in Southern Montana.

2. The proposed settlement includes payment of the City's water credit of \$1,186,061.83. When the amount of the water credit is deducted from the total settlement amount (\$3,250,000.00), the total cost of settlement is \$2,063,938.17. Thus, the actual settlement price is less than the \$2,500,000.00 paid by Yellowstone Valley Electric.

3. The legal costs and expenses, including expert witness fees, associated with the Bankruptcy Adversary litigation and the main Bankruptcy case, are estimated to be in excess of \$1,000,000.00.

4. There are additional costs and expenses that the City will incur in connection with the Adversary litigation and the Bankruptcy case. Over the next year, these cases will require a substantial amount of the City Manager's and staffs' time. Additionally, representatives of the City need to be present for the three week Confirmation Hearing and the three week Adversary trial. Continued litigation will also require substantial time commitments of the Mayor and all of the City Commissioners as well as other staff members. We cannot understate how much time this is going to take.

We are concerned that these cases may interfere with the ability of the City Manager and other staff members to handle other City business.

5. We cannot estimate how much it will cost the City and ECP's electric customers to continue buying energy from Southern Montana at rates that are higher than the market rate. We can only estimate that those amounts will be substantial. The City should realize substantial cost savings by leaving Southern Montana.

6. Historically, Southern Montana has denied the City and ECP access to critical information that it deemed "confidential." Southern Montana alleges that certain third-parties, such as Morgan Stanley, will not negotiate or contract with Southern, unless they have assurances that certain information and trade secrets will remain confidential. Southern also claims that it will suffer significant financial injury if certain information is made public. In the past, Southern has refused to provide the City with information. Without that information, the City Commission has not had all of the information that it needed to make informed decisions. If the City remains a part of Southern Montana we expect this problem to remain, if not become worse. It is unlikely that the City Commission is going to receive all of the information that it needs to make informed decisions in the future without additional litigation.

7. If the City is required to remain a member of Southern, we strongly recommend that the City engage an energy and utility expert to provide advice and consultation services to the City and ECP. The energy and utility business is highly technical and complex. There are significant sums of money involved. While a consultant would be an additional expense, we believe that it would be prudent for the City to retain an expert to assist it in navigating through this technical field.

8. The Trustee's attorneys have acknowledged that the City did not participate in the construction of HGS. Accordingly, the Trustee's attorneys have represented that the City will not have to pay for the cost of the construction and maintenance of HGS. The attorneys have represented that the City will pay a different electric rate than the four remaining cooperative members of Southern. We very much appreciate the assurances that we have been given by the Trustee's attorneys, however, those terms are not currently reflected in the Proposed Plan of Reorganization or Disclosure Statement. The four remaining cooperative members of Southern may object to the City paying a lower rate. Other Creditors, including the Secured Creditor may also object.

9. The exact dollar amount of damages that the Trustee is seeking from the City is not a finite number at this time, however we know that the Trustee is seeking repayment of the water credit (\$1,186,061.83), plus \$60,000,000.00 for stranded cost damages, plus other damages and costs. If the Trustee prevails, the Trustee may be entitled to recover his attorney fees and costs. The Trustee's attorneys are charging more than twice the Moulton Bellingham hourly rate. Accordingly, if the Trustee prevails, his claim for attorney fees and costs may be several million dollars.

10. The Court has set a hearing in late July in order to determine the value of HGS. We believe that HGS is worth substantially less than the secured debt. The Trustee contends that HGS and the All Requirements Contracts are worth approximately \$5.6 million. This means that the Secured Lender may be substantially undersecured. This raises the possibility that the Secured Lender may make an election under Section 1111(b) of the Bankruptcy Code. If the Secured Lender makes an 1111(b) election, it may be entitled to receive payment of the total amount of its debt over a period of time. In other words, if the Secured Lender is owed \$85 million it would be entitled to a stream of payments that would be made over a number of years that would total \$85 million. While the present value of that stream of payments would be less, the total amount to be paid to the secured creditor could be significantly larger and could have a very negative impact on the Plan of Reorganization and ultimately the electric rates that will be paid by Southern's members.

11. Southern Montana is surrounded by uncertainty. That uncertainty adds an additional risk element. The City should recognize the possibility that some or all of the member cooperatives remaining in Southern Montana could file bankruptcy. Potentially, the City could be left as the sole remaining member of Southern. If the member cooperatives file bankruptcy, they may be able to substantially lower their debt and provide their members with more competitive electric rates. We have no reason to believe that any of the cooperatives are presently contemplating bankruptcy. We simply want the City to recognize that this is a possibility. If the Secured Creditor is not cooperative, the member cooperatives may be forced to reevaluate their options. Should that happen, we believe that filing for bankruptcy could be a realistic option for them.

12. If the Trustee is successful in his efforts to require The City and ECP to take all measures necessary to avoid further reduction in their electric load, the City may be forced into litigation with local businesses in order to require them to remain with ECP or to return to ECP. That would require additional costs, both economic and non-economic.

13. We believe that Southern Montana violated Montana's Rural Electric Cooperative Act when it made the City a member. Cooperatives are exempt from PSC regulation. We argue that when Southern Montana violated the Rural Cooperative Act and made the City a member, it waived and lost its exemption from PSC regulation. If we prevail on that argument the PSC may assert some level of jurisdiction over Southern Montana. We would hope and expect that the PSC would review Southern Montana's rates. However, we have no assurances that the PSC would in fact do that. We would be in uncharted waters. PSC regulation may be helpful and may provide some level of protection for ECP customers. However, PSC regulation would undoubtedly also add additional costs that ultimately would have to be paid by Southern and the rate payers.

V. Our Recommendation.

In view of the risks and uncertainty outlined in this letter, we recommend that the City and ECP accept Justice Regnier's number (\$3,250,000.00) and authorize settlement with Southern Montana and its Trustee according to the terms outlined above. We recommend to the Commission and the ECP Board of Directors that they authorize City Manager Greg Doyon to sign the proposed Settlement Agreement that is attached.

The City cannot change the past. Southern Montana has been a financial disaster. We believe that the proposed settlement is the best settlement that the City is going to get and that the only other alternative is to continue litigation.

The settlement amount is significant. We acknowledge that it is going to be difficult and painful for the City to pay the settlement amount. Unfortunately, however, we believe that is the best and wisest course of action. If we continue with the litigation, we can only guarantee that the City will incur substantial additional attorney fees and litigation expenses as well as the cost of the time and effort of City management and staff. While we are confident of the City's case, we must acknowledge that there is substantial litigation risk. We cannot guarantee how ultimately the Bankruptcy Court will rule. Additionally, there is Bankruptcy risk. If Southern Montana gets a Chapter 11 Plan confirmed, the City will be forced to remain a member of Southern and will be forced to continue paying inflated energy prices for at least ten years and potentially through December 31, 2048. By settling now, the City can substantially limit its costs and expenses and eliminate its litigation risk and the bankruptcy risk associated with Southern Montana. Our recommendation is to settle now and thereby make a clean, final, and absolute break with Southern Montana. The proposed settlement, while difficult, provides certainty and will end the Southern Montana controversy.

Sincerely,

MOULTON BELLINGHAM PC



DOUG JAMES

DJ:jlm