Electric Cooperative Mergers & Combinations
Sutherland’s Electric Cooperative Practice

- Nationally preeminent electric cooperative practice group has been representing electric cooperatives for over 35 years
- Sampling of our recent experience counseling electric cooperatives on mergers and other combinations:
  - Assisted in the combination of two G&Ts through formation of a “super G&T” and ultimate merger of the G&Ts
  - Represented G&T in the acquisition of assets via merger of two cooperatives into G&T
  - Structured medium- and long-term asset management arrangements for joint power supply operations for electric cooperatives
Why This Webinar is Relevant

- Economy is putting pressure on rates
- Increase in cost of building new generation
- Market has resulted in changed positions
  - Some coops have lost load and are “long”
  - Some coops are still growing rapidly
  - Some distribution cooperatives have changed power supply arrangements
- Aging management and workforce
- Outlook for RUS financing opportunities unclear
- Lenders and third parties seek stronger credits
- **Result**: Opportunities for long-term benefits through mergers or other transactions
Coop M&A Issues Webinar Series

- Webinar I – Power Asset M&A
- Webinar II – Electric Cooperative Mergers & Combinations
  - Tuesday, May 24, 2011 – 1:00-2:00 P.M. ET
- Webinar III – Joint Ownership Arrangements
  - Tuesday, August 23, 2011 – 1:00-2:00 P.M. ET
- Webinar IV – Considerations for Cooperatives in Renewable Energy
  - Tuesday, October 25, 2011 – 1:00-2:00 P.M. ET
Exelon-Constellation Merger / Duke-Progress Merger

Source:
http://www.exelonconstellationmerger.com/sites/default/files/Exelon_Constellation_Analyst_Presentation.pdf (see p. 15)
Why merge?

• “Our industry is entering a building phase where we must ... reduce our environmental footprints and become more efficient. By merging our companies, we can do that more economically for our customers .... Combining Duke Energy and Progress Energy creates a utility with greater financial strength.”
  ▪ – Jim Rogers, Duke Energy

• The merger “increases the scale and scope of the business,” “diversifies the generation portfolio,” “increases geographic diversity of generation, load and customers,” and “reduces cost of capital.”
  ▪ – Exelon/Constellation merger announcement
Possible Benefits of Merger/Combination

- Increase access to capital and lower credit costs
- Improve efficiency of use of generation resources (joint dispatch)
- Diversify generation portfolio
- Diversify load (type, geography)
- Improve load factor
- Control or reduce capital expenditures for future power supply and transmission
- Reduce O&M costs (e.g., equipment procurement and utilization)
- Increase access to, and leverage in, organized wholesale power markets
- Reduce overall labor force and personnel costs
- Better utilize physical facilities (offices, warehouses, etc.)
- Other economies of scale (such as system planning, system construction)

**Overall objective: Improve ability to provide reliable, low-cost power**
Overview of Possible Structures

- **Mergers & Business Combinations**
  - Structuring issues
  - Other legal issues

- **Alternative Structures**
  - Pooling of power supply
  - Combined services

**Business Combination Spectrum**

- Pooling Arrangement/Strategic Alliance: Lowest impact; fewer gained efficiencies
- New Service Company
- Super G&T
- Full Merger: Highest impact on operations; more potential for gained efficiencies
Threshold Considerations

• Management of surviving coop
  ▪ Board of directors
  ▪ Key executives
• Articles/bylaws of surviving coop
• Member contracts
  ▪ Rates [and State PUC]
  ▪ Patronage capital accounts
• Liabilities
• Dissenters’ rights
• Federal and state/local tax considerations
• Risk allocation
• Third-party approvals
Merger/Consolidation—Overview

- Two coops merged into one coop
  - Consolidation: two coops become one new coop
- Surviving entity has all assets and liabilities of both, combined operations and governance

Example of a direct merger between two Cooperatives with Coop B as the “surviving” entity.

Example of consolidation where two existing coops become one new coop.
Asset Transfer – Overview

- One coop sells all or substantially all of its assets to another coop
  - Selling coop’s members need to become members of acquiring coop, enter into power purchase contracts
  - Selling coop members need to obtain patronage capital accounts in acquiring coop
- Asset transfer can achieve substantially the same effect as merger
- Could assume less than all liabilities
Officers’ and Directors’ Duties

• Act in good faith in interest of the cooperative
• Use reasonable care
• “Crystal ball” judgment is not the standard – following a well designed process will earn protection of the “Business Judgment Rule”
How Much Diligence is Due?

• Not every opportunity requires analysis of every last detail
• Start with high level, preliminary consideration of material matters
• Move to next level if no “deal breakers” identified
• Document your decisions
Know What You’re Getting

• **Areas of Legal Due Diligence**
  - Commercial
  - Electric regulatory
  - Financing Matters
  - Corporate/Governance
  - Tax (Federal, State and Local)
  - Environmental
  - Real Property
  - Litigation
  - Employee Matters and Benefits
  - IP

• **Non-legal due diligence is also critical—e.g., operational, commercial, accounting, insurance, risk management**

• **Context and experience are critical when conducting your due diligence.**
Key State Corporate Law Questions

• Is a merger an option?
• What decisions must be made by the Boards of Directors?
• What decisions must be made by the Members?
  ▪ For G&Ts, must members’ members approve?
• What notices must be provided?
• What rights do dissenting members have?
• What statutory provisions and court interpretations of the duties of loyalty and care need to be taken into consideration in developing the process for analyzing a potential transaction?
Key Tax Considerations

• Implications on Tax Status is of Critical Importance in Structuring Merger or Other Combination

• **Scenario #1:** 501(c)(3) Tax-Exempt Electric Cooperative Acquires Taxable Cooperative via Merger or Asset Acquisition
  
  ▪ 85% member-income test for tax-exempt status
  ▪ Must diligence acquired operations if significant income derived from persons who do not become members of acquiring electric cooperative
  ▪ Some exceptions to “non-member income”
Key Tax Considerations – Cont’d

• **Scenario #2:** Taxable Cooperative Acquires Tax-Exempt Cooperative via Merger or Asset Acquisition
  - No effect if net earnings from business conducted with former members allocated as patronage dividends
  - Other non-member income that did not violate 85% test for tax-exempt status may be taxed unless certain conditions are met

• Important to also consider tax effect on acquired electric cooperative!
Indenture Considerations

- Pro forma MFI calculations
- Valuation of acquired assets
- Majority debtholder approvals
Third-Party Approvals

- Bank/private placement lenders
- Joint owners of assets
- Lessors in sale/leasebacks
- Other material contracts
- Pollution control bond trustees
- Vendors with long-term service/parts contracts
- Long-term power suppliers or purchasers
Governmental Approvals

- RUS
- FERC
- State PUC
- HSR Act
FERC Jurisdiction

- **Change in FERC Jurisdiction**
  - 4 million MWh test
  - RUS Borrower status
- **Consequences of FERC Jurisdiction**
  - Wholesale power sale and transmission rate regulation (level and design) (including member all-requirement contracts)
    - Delay in approvals (up to 5 month suspension)
    - Lawyers and experts fees
    - Potential for interventions (large users, dissident members or state commissions)
    - Potential for complaints
  - Need for approval to terminate a sale
  - Need for prior approval for sales of jurisdictional assets
  - Numerous other compliance requirements
Some Other Considerations

- Public relations and communication plan
- Accounting treatment
- Employment issues / labor union contracts, retirement plans, etc.
- Preserving access to federal preference power (e.g. WAPA, SEPA)
- Assignment of environmental and other permits
- RTO/ISO coordination
- State PUC jurisdiction
- Condemnation powers
- State taxes
- PUHCA
Alternative Structures

• If barriers to merger or other full combination are insurmountable or objectives are more modest, alternative structures may achieve objectives

• Many variations are possible
Sample Alternative Structures – Pooling Arrangement

Coop A Resources

Coop B Resources

Contract Governing Joint Pooling Operations

Coop A Load

Coop B Load
Sample Alternative Structures – Pooling Arrangement

- **Description**
  - Pooled operation of generation assets/PPAs
  - Joint power supply planning

- **Primary Effects**
  - More efficient use of power supply assets
  - More efficient use of capital for new power supply assets
  - No change in governance
  - Limited change in management and staff personnel
Sample Alternative Structures – New Service Company

New Service Company

Contracts with Coop #1 & Coop #2

Coop #1
- Board of Directors
- Management

Member Contracts

Coop Assets
- Management
- Generation O&M
- Transmission O&M
- Finance
- Accounting
- Procurement
- Human Resources
- Scheduling and Dispatch
- Future Resource Planning

Coop #2
- Board of Directors
- Management

Member Contracts

Coop Assets
Sample Alternative Structures – New Service Company

• **Description**
  - New service company formed to provide services to both coops
  - Some or all employees transferred to Service Company
  - Services could include any or all of the functions currently performed by the Coops

• **Primary Effects**
  - Change in management and staff personnel, with increased management and staffing efficiencies
  - No increase in efficiency in utilization of power supply assets or use of capital for new power supply assets
  - No/some change in governance
Sample Alternative Structures – Super G&T (one example)

Super G&T

Board of Directors
Management

Contracts with G&T #1 & G&T #2

G&T #1
Board of Directors
Management
G&T Assets
Member Contracts

G&T #2
Board of Directors
Management
Member Contracts
G&T Assets

• Management
• Generation O&M
• Finance
• Transmission O&M
• Accounting
• Procurement
• Human Resources
• Scheduling and Dispatch
• Future Resource Planning
Sample Alternative Structures – Super G&T

• Description
  ▪ Super G&T can combine pooling and service company

• Primary Effects
  ▪ More efficient use of power supply assets
  ▪ More efficient use of capital for new power supply assets, through co-ownership or otherwise
  ▪ No change in governance
  ▪ Management and staff personnel combined at Service Company, with increased management and staffing efficiencies (depending on number of functions performed by service company)
Conclusion

• Atmosphere is favorable for business combinations
• Many challenges
• Upfront structuring and rigorous process can overcome challenges
Questions for the Presenters

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Thank You

• Next Webinar: Joint Ownership Arrangements
  ▪ Tuesday, August 23, 2011 – 1:00-2:00 P.M. ET

• G & T Accounting and Finance Association Meeting
  ▪ Presentation on G&T mergers and combinations
  ▪ Tuesday, June 21, 2011

• www.cooplawblog.com