Minnesota Public Utilities Commission

Staff Briefing Papers

Meeting Date: Tuesday, August 25, 2009 .....*Agenda Item #__5___

Company:	Otter Tail Power Company
	In the Matter of the Petition of Otter Tail Corporation for Approval of a Standstill Agreement with Cascade Investment, LLC
Docket No.	E-017/M-09-656
Issue(s):	Shall the Commission approve the Standstill Agreement with Cascade Investment, LLC?
Staff:	Stuart Mitchell 651-201-2242
	Clark Kaml..... 651-201-2246

Relevant Documents

OTP Initial Filing .....June 1, 2009
OES Initial Comments.....June 26, 2009
OTP Reply Comments and Supplement .....July 15, 2009
OES Supplemental Comments .....July 17, 2009

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Statement of the Issue

Shall the Commission approve the Standstill Agreement with Cascade Investment, LLC?

Background

On June 1, 2009, Otter Tail Corporation, d/b/a Otter Tail Power Company, filed a petition with the Commission for approval of a Standstill Agreement with Cascade Investment, LLC pursuant to Minn. Stat. § 216B.48 and Minn. Rules Parts 7825.1900 to 7825.2300. Cascade is an affiliate of OTC, as it owns more than 5% of OTC stock. OTC asked that the Agreement be approved as of its effective date, May 1, 2009.

Under Section 673 of the Minnesota Business Corporations Act (MBCA), Minn. Stat. § 302A.673, a shareholder in a publicly traded Minnesota corporation becomes an "interested shareholder" upon acquiring 10 percent or more of the corporation's outstanding shares. A shareholder that acquires more than 10 percent of the outstanding shares of a Minnesota corporation is subject to certain restrictions in its dealings with the corporation for a period of four years after crossing the 10% threshold. For four years such a shareholder is not permitted to enter into certain "business combinations" with the corporation, which includes transactions that involve certain share exchanges and share issuances, mergers, and certain sales and other transactions involving the assets of the corporation.

The MBCA permits a corporation, upon request from a shareholder interested in acquiring 10 percent or more of the outstanding shares, to form a committee of the corporation's board of directors to consider approving the transaction which would result in the shareholder passing the 10 percent threshold. If the committee approves the transaction, the MBCA's statutory restrictions on the shareholder do not apply.

Cascade asked OTC's Board of Directors to form such a committee, which then approved Cascade procuring shares that would increase its interest over 10 percent, provided Cascade agreed to enter into the Standstill Agreement. The primary effects of the Agreement are to permit Cascade to increase its interest in Otter Tail above 10 percent without application of the statutory restrictions of § 673 of the MCBA and to restrict Cascade from increasing its interest in Otter Tail to 20 percent or more, joining in any group or voting trust or participating in any proxy solicitation relating to Otter Tail for at least four years.

On June 26, 2009, the OES submitted comments recommending approval of the petition.

On July 1, 2009, Otter Tail Corporation consummated its holding company restructuring, converting Otter Tail Power Company from a division of the Corporation to a subsidiary corporation.

On July 15, 2009, OTP submitted reply comments and a supplement. The Agreement filed initially automatically terminated on restructuring, and OTC entered into a new Standstill Agreement with Cascade on July 1, 2009. The new Standstill Agreement is substantively identical to the old one, except for references to OTC having concluded the holding company restructuring. OTP included in this filing both the new Standstill Agreement and a blackline

version of the replacement Agreement, reflecting the changes from the prior version. Staff may refer to either the Agreement or the Agreements throughout the rest of this paper.

On July 17, 2009, the OES submitted supplemental comments, recommending approval of the new Standstill Agreement between Otter Tail Corporation and Cascade.

Subd. 3 of Minn. Stat. § 216B.48 reads as follows:

> **Subd. 3.Contract between utility and affiliated interest.**
> No contract or arrangement, including any general or continuing arrangement, providing for the furnishing of management, supervisory, construction, engineering, accounting, legal, financial, or similar services, and no contract or arrangement for the purchase, sale, lease, or exchange of any property, right, or thing, or for the furnishing of any service, property, right, or thing, other than those above enumerated, made or entered into after January 1, 1975 between a public utility and any affiliated interest as defined in subdivision 1, clauses (1) to (8), or any arrangement between a public utility and an affiliated interest as defined in subdivision 1, clause (9), made or entered into after August 1, 1993, is valid or effective unless and until the contract or arrangement has received the written approval of the commission. Regular recurring transactions under a general or continuing arrangement that has been approved by the commission are valid if they are conducted in accordance with the approved terms and conditions. Every public utility shall file with the commission a verified copy of the contract or arrangement, or a verified summary of the unwritten contract or arrangement, and also of all the contracts and arrangements, whether written or unwritten, entered into prior to January 1, 1975, or, for the purposes of subdivision 1, clause (9), prior to August 1, 1993, and in force and effect at that time. The commission shall approve the contract or arrangement made or entered into after that date only if it clearly appears and is established upon investigation that it is reasonable and consistent with the public interest. No contract or arrangement may receive the commission's approval unless satisfactory proof is submitted to the commission of the cost to the affiliated interest of rendering the services or of furnishing the property or service to each public utility. Proof is satisfactory only if it includes the original or verified copies of the relevant cost records and other relevant accounts of the affiliated interest, or an abstract or summary as the commission may deem adequate, properly identified and duly authenticated, provided, however, that the commission may, where reasonable, approve or disapprove the contracts or arrangements without the submission of cost records or accounts. The burden of proof to establish the reasonableness of the contract or arrangement is on the public utility.

Subd. 1 of Minn. Stat. § 302A.673 reads as follows:

> **302A.673 BUSINESS COMBINATIONS.**
> **Subdivision 1.Business combination with interested shareholder; approval by directors.**
> (a) Notwithstanding anything to the contrary contained in this chapter (except the provisions of subdivision 3), an issuing public corporation may not engage in any

business combination, or vote, consent, or otherwise act to authorize a subsidiary of the issuing public corporation to engage in any business combination, with, with respect to, proposed by or on behalf of, or pursuant to any written or oral agreement, arrangement, relationship, understanding, or otherwise with, any interested shareholder of the issuing public corporation or any affiliate or associate of the interested shareholder for a period of four years following the interested shareholder's share acquisition date unless the business combination or the acquisition of shares made by the interested shareholder on the interested shareholder's share acquisition date is approved before the interested shareholder's share acquisition date, or on the share acquisition date but prior to the interested shareholder's becoming an interested shareholder on the share acquisition date, by a committee of the board of the issuing public corporation formed in accordance with paragraph (d).

(b) If a good faith definitive proposal regarding a business combination is made in writing to the board of the issuing public corporation, a committee of the board formed in accordance with paragraph (d) shall consider and take action on the proposal and respond in writing within 30 days after receipt of the proposal by the issuing public corporation, setting forth its decision regarding the proposal.

(c) If a good faith definitive proposal to acquire shares is made in writing to the board of the issuing public corporation, a committee of the board formed in accordance with paragraph (d), shall consider and take action on the proposal and respond in writing within 30 days after receipt of the proposal by the issuing public corporation, setting forth its decision regarding the proposal.

(d)(1) When a business combination or acquisition of shares is proposed pursuant to this subdivision, the board shall promptly form a committee composed solely of one or more disinterested directors. The committee shall take action on the proposal by the affirmative vote of a majority of committee members. No larger proportion or number of votes shall be required. Notwithstanding the provisions of section 302A.241, subdivision 1, the committee shall not be subject to any direction or control by the board with respect to the committee's consideration of, or any action concerning, a business combination or acquisition of shares pursuant to this section.

(2) If the board has no disinterested directors, the board shall select three or more disinterested persons to be committee members. Committee members are deemed to be directors for purposes of sections 302A.251, 302A.255, and 302A.521.

(3) For purposes of this subdivision, a director or person is "disinterested" if the director or person is neither an officer nor an employee, nor has been an officer or employee within five years preceding the formation of the committee pursuant to this section, of the issuing public corporation, or of a related organization.

Party Positions

Otter Tail Corporation

OTC asked that the Commission approve each of the Standstill Agreements as of their respective effective dates.

Office of Energy Security

The OES reviewed the Agreements with respect to the two statutory tests (reasonableness and public interest), focusing on the impact of the contracts on OTP's ratepayers. It found that neither contract imposed additional cost on OTP's ratepayers, nor do they have any impact on the regulated operations of OTP. Therefore, the OES concluded the contracts are not counter to the interests of OTP's ratepayers.

The OES continued, saying that because the contracts are voluntary, they are clearly beneficial to both OTC and Cascade. In particular, the contracts allow OTC and Cascade to enter into beneficial transactions which would not be permitted under Minn. Stat. § 302A.673, and limit Cascade's ownership to less than 20%. This limiting provision further benefits OTP's ratepayers, because Cascade's main focus, unlike OTP, is not likely to be OTP's ratepayers.

Based on this analysis, the OES concluded the contracts are both reasonable and not counter to the public interest, and recommended their approval by the Commission.

Staff Analysis

Essentially, the Agreement places the following restrictions on Cascade:

- It may not acquire or propose to acquire shares if the acquisition would result in Cascade owning 20% or more of the outstanding shares, except by way of stock dividends or through a third party acquisition of OTC that is both recommended by the OTC Board of Directors and found to be fair to shareholders by an independent investment banker.
- It may not form or join any group of shareholders to acquire or hold shares.
- It may not deposit shares in a voting trust or subject them to a voting agreement or similar arrangement.
- It may not become a participant in any solicitation of proxies to vote or to seek to influence the voting of shares, except in matters recommended by OTC's Board of Directors.

Despite the restrictions, Cascade has the right to terminate the Agreement "…upon written notice by Cascade to the Company, any time after a third party (A) commences (for the purposes of Rule 14d-2 under the Exchange Act Rules) a tender offer or exchange offer for at least 50% of the outstanding Voting Securities; (B) publicly announces the commencement of a proxy contest with respect to the election of any directors of the Company; or (C) enters into a definitive agreement with the Company contemplating the acquisition (by way of merger, tender offer, consolidation, business combination or otherwise) of at least 50% of the outstanding Voting Securities or all or any material portion of the assets of the Company…" As staff reads this provision, Cascade would have the right, just by providing notice, to terminate the Agreement and participate in certain actions it appeared to promise not to take, when faced with any of these possibilities.

Staff agrees with the OES that the Agreement enables Cascade and the OTC Board of Directors to enter into otherwise prohibited transactions that both may see as beneficial. These

transactions need not necessarily benefit OTP ratepayers, though, and they reflect, if anything, enhancements to these parties' *private* interests. Similarly, staff does not see the benefit to ratepayers that the OES did in Cascade's acquisition of up to 20% of OTC, as opposed to the *status quo*, that is, up to 10% of OTC. In fact, all that OTC said in its filing as to why the agreement is in the public interest is this:

> The Standstill Agreement will not have any impact on Otter Tail's electric customers. It does not involve a purchase or sale of goods or services that will impact Otter Tail's cost of providing electric service. The Agreement's impact is limited to the Company's relationship with its shareholder, and the Agreement provides reasonable restrictions on Cascade as it increases its interest in Otter Tail over 10%.

Staff asked what business combination is contemplated with Cascade that it would be restricted from entering into without the Standstill Agreements under Minn. Stat. § 302A.673, and the Company initially responded that none are contemplated, but it wants to preserve the option of, for example, another loan from Cascade to OTC. Staff admits to being completely unfamiliar with the MBCA, but staff reads the definition of "business combination" found in Minn. Stat. § 302A.011, Subd. 46 to apply to **ownership** transactions, not loans:

> **Subd. 46.Business combination.**
> "Business combination," when used in reference to any issuing public corporation and any interested shareholder of the issuing public corporation, means any of the following:
> (a) any merger of the issuing public corporation or any subsidiary of the issuing public corporation with (1) the interested shareholder or (2) any other organization (whether or not itself an interested shareholder of the issuing public corporation) that is, or after the merger would be, an affiliate or associate of the interested shareholder, but excluding (i) the merger of a wholly owned subsidiary of the issuing public corporation into the issuing public corporation, (ii) the merger of two or more wholly owned subsidiaries of the issuing public corporation, or (iii) the merger of an organization, other than an interested shareholder or an affiliate or associate of an interested shareholder, with a wholly owned subsidiary of the issuing public corporation pursuant to which the surviving organization, immediately after the merger, becomes a wholly owned subsidiary of the issuing public corporation;
> (b) any exchange, pursuant to a plan of exchange under section 302A.601, subdivision 2, or a comparable statute of any other state or jurisdiction, of shares or other securities of the issuing public corporation or any subsidiary of the issuing corporation or money, or other property for shares, other securities, money, or property of (1) the interested shareholder or (2) any other organization (whether or not itself an interested shareholder of the issuing public corporation) that is, or after the exchange would be, an affiliate or associate of the interested shareholder, but excluding the exchange of shares of a domestic or foreign corporation, other than an interested shareholder or an affiliate or associate of an interested shareholder, pursuant to which the domestic or foreign corporation,

immediately after the exchange, becomes a wholly owned subsidiary of the issuing public corporation;
(c) any sale, lease, exchange, mortgage, pledge, transfer, or other disposition (in a single transaction or a series of transactions), other than sales of goods or services in the ordinary course of business or redemptions pursuant to section 302A.671, subdivision 6, to or with the interested shareholder or any affiliate or associate of the interested shareholder, other than to or with the issuing public corporation or a wholly owned subsidiary of the issuing public corporation, of assets of the issuing public corporation or any subsidiary of the issuing public corporation (1) having an aggregate market value equal to ten percent or more of the aggregate market value of all the assets, determined on a consolidated basis, of the issuing public corporation, (2) having an aggregate market value equal to ten percent or more of the aggregate market value of all the outstanding shares of the issuing public corporation, or (3) representing ten percent or more of the earning power or net income, determined on a consolidated basis, of the issuing public corporation except a cash dividend or distribution paid or made pro rata to all shareholders of the issuing public corporation;
(d) the issuance or transfer by the issuing public corporation or any subsidiary of the issuing public corporation (in a single transaction or a series of transactions) of any shares of, or other ownership interests in, the issuing public corporation or any subsidiary of the issuing public corporation that have an aggregate market value equal to five percent or more of the aggregate market value of all the outstanding shares of the issuing public corporation to the interested shareholder or any affiliate or associate of the interested shareholder, except pursuant to the exercise of warrants or rights to purchase shares offered, or a dividend or distribution paid or made, pro rata to all shareholders of the issuing public corporation other than for the purpose, directly or indirectly, of facilitating or effecting a subsequent transaction that would have been a business combination if the dividend or distribution had not been made;
(e) the adoption of any plan or proposal for the liquidation or dissolution of the issuing public corporation, or any reincorporation of the issuing public corporation in another state or jurisdiction, proposed by or on behalf of, or pursuant to any written or oral agreement, arrangement, relationship, understanding, or otherwise with, the interested shareholder or any affiliate or associate of the interested shareholder;
(f) any reclassification of securities (including without limitation any share dividend or split, reverse share split, or other distribution of shares in respect of shares), recapitalization of the issuing public corporation, merger of the issuing public corporation with any subsidiary of the issuing public corporation, exchange of shares of the issuing public corporation with any subsidiary of the issuing public corporation, or other transaction (whether or not with or into or otherwise involving the interested shareholder), proposed by or on behalf of, or pursuant to any written or oral agreement, arrangement, relationship, understanding, or otherwise with, the interested shareholder or any affiliate or associate of the interested shareholder, that has the effect, directly or indirectly, of increasing the proportionate share of the outstanding shares of any class or series of shares

> entitled to vote, or securities that are exchangeable for, convertible into, or carry a right to acquire shares entitled to vote, of the issuing public corporation or any subsidiary of the issuing public corporation that is, directly or indirectly, owned by the interested shareholder or any affiliate or associate of the interested shareholder, except as a result of immaterial changes due to fractional share adjustments;
> (g) any receipt by the interested shareholder or any affiliate or associate of the interested shareholder of the benefit, directly or indirectly (except proportionately as a shareholder of the issuing public corporation), of any loans, advances, guarantees, pledges, or other financial assistance, or any tax credits or other tax advantages provided by or through the issuing public corporation or any subsidiary of the issuing public corporation.

If the statute is concerned only with ownership, it seems likely a further loan would **not** be prohibited.

Under the affiliated interest statute, "The commission shall approve the contract or arrangement made or entered into after that date only if it clearly appears and is established upon investigation that it is reasonable and consistent with the public interest." Staff has been unable to discern what effect, if any, the Agreements would have upon the public interest.

On Thursday and Friday, August 13, and 14, 2009, staff initiated a conversation with Mr. Gerhardson, counsel for OTP, expressing the concerns noted above. On Monday, August 17, 2009, Mr. Gerhardson responded as follows:

> I am writing to respond to 3 questions you posed to Tom Bailey (Cascade's local counsel) and me on a phone call Friday. If you have any follow up questions, please don't hesitate to contact me any time.
>
> Your questions and our responses are as follows:
>
> 1) Under the agreement is Cascade required to support OTC Management in all proxy fights (Section 2(a)(4)) except if a third party publicly announces a proxy contest, in which case Cascade would be free to not side with OTC Management (Section 6 (c)(iii)(B))?
>
> Response:
> The Standstill Agreement does not restrict Cascade's right to vote its shares in any matter properly coming before the OTC shareholders, including a proxy fight. Section 2(a)(4) merely prohibits Cascade from (i) actively seeking to influence others with respect to any matter that will be voted upon by OTC shareholders, and (ii) soliciting proxies from others (i.e., requesting that other shareholders give Cascade the authority to vote such shareholders' shares in the way Cascade recommends), in each case without prior approval of OTC's Board of Directors. Therefore, if OTC's shareholders are asked to vote on any matter during the term of the Standstill Agreement, Cascade is prohibited, without prior approval of

OTC's Board of Directors, from attempting to influence the votes of any other shareholder and from soliciting proxies of any other shareholders, but Cascade would be permitted to vote its own shares in whatever way it desires.
Cascade's right to terminate the Standstill Agreement pursuant to Section 6(c)(iii)(B) is limited to the situation where a third party publicly announces the commencement of a proxy contest involving the election of one or more OTC directors. The public announcement of a proxy contest is a rare event and must comply with stringent technical requirements promulgated by the United States Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. In the rare circumstance that a proxy contest were announced by a third party, it would be commercially unreasonable to require that Cascade be restricted by the Standstill Agreement from being able to protect its substantial investment in OTC.
Cascade has the ability to terminate the Standstill Agreement under certain circumstances, but those circumstances are limited and each was carefully negotiated to give Cascade the ability to protect its investment in OTC in the event of certain rare occurrences, such as the commencement of a hostile takeover or proxy contest by a third party.

2) Can we give an example of a business combination that is beneficial to OTC and possible under the agreement, but would not be possible under the statute (with Cascade over 10% and without the Agreement)?

Response:
When the OTC Board voted to allow Cascade to exceed the 10% ownership threshold and therefore avoid the limitations imposed by Section 673 of the Minnesota Business Corporation Act (MBCA), a Special Committee of the Board carefully considered both the proposed investment of additional capital in OTC's common stock and the consequences of Cascade increasing its ownership in OTC. The Special Committee's approval was contingent upon Cascade entering into the Standstill Agreement so that Cascade would have the freedom to invest more money in OTC's common equity, but OTC would have the ability to control whether and to what extent Cascade could increase its ownership to and beyond 20%. In addition, in granting its approval the Special Committee also allowed for OTC and Cascade to engage in certain transactions during the four years after Cascade's acquisition of 10% or more of the outstanding voting shares of OTC, which transactions would be beneficial to OTC but would have otherwise have been prohibited by Section 673 of the MBCA.
If the Special Committee of OTC's Board had not voted to permit Cascade to exceed the 10% threshold, the Standstill Agreement would not have been entered into, and Section 673 of the MBCA would have prohibited, among other things, certain share exchanges and share issuances to or with Cascade, and any merger of OTC or any of its subsidiaries with Cascade, as well as certain asset transfers with Cascade. There may be situations where the ability of OTC to enter into transactions with Cascade would be beneficial to OTC, such as the sale of certain businesses or other assets, or the participation in joint ventures and partnerships

involving assets of OTC, that would otherwise have been prohibited under Section 673 of the MBCA if Cascade owned more than 10% of OTC's common stock without the prior approval by the Special Committee and, therefore, the Standstill Agreement.
In addition, if OTC is ever the subject of a hostile takeover attempt, OTC's Board of Directors will want to consider alternatives in the exercise of its fiduciary duties, including the possibility of a negotiated transaction for Cascade to acquire OTC rather than the hostile bidder. If the Special Committee had not approved the Cascade purchases resulting in Cascade owning more than 10%, this alternative would not have been available under Section 673 of the MBCA even if it were in the best interests of OTC's shareholders and the public. The Special Committee's approval, which was conditioned on the Standstill Agreement, gives OTC the flexibility to make such a determination at the appropriate time.
It should be noted that Otter Tail is not currently seeking Commission approval for any such transaction and if any such transaction is contemplated in the future, Otter Tail will seek required Commission approvals at that time. However, without the Standstill Agreement, such beneficial transactions would be prohibited by Section 673 of the MBCA.

3) In light of these responses (and based on the Agreement as a whole), can we provide a succinct statement of why this Agreement is in the public interest?

Response:
The Special Committee of OTC's Board determined that its approval of Cascade increasing its ownership in OTC above 10%, conditioned upon Cascade signing the Standstill Agreement, is in OTC's best interest. It allows OTC to receive the economic benefits of further investments by Cascade, an investor with which OTC management has had favorable experience, and it provides important flexibility allowing OTC's Board to consider transactions with Cascade that are beneficial to OTC but would otherwise be prohibited under Section 673 of the MBCA. At the same time, the Standstill Agreement contractually prohibits Cascade from increasing its ownership of OTC to 20% or more of the outstanding voting securities without the prior consent of OTC or in extreme circumstances. Based upon Cascade's favorable history with OTC and the control limitation in the Standstill Agreement, OTC believes the agreement appropriately balances benefits and risks. For these reasons, OTC believes that the Standstill Agreement is in the public interest.

Staff thinks these responses satisfactorily address its concerns, and recommends that the Commission approve the Agreements.

Alternatives

1. Find that the Standstill Agreements are reasonable and consistent with the public interest and approve them as of their effective dates.
2. Find that the Standstill Agreements are not reasonable and/or are inconsistent with the public interest and reject the petition.
3. Find that there is nothing in the record upon which to make a finding of reasonableness or consistency with the public interest.
    a. Require the Company to make a filing showing why the petition should be approved; or
    b. Reject the petition.

Recommendation

Staff recommends Alternative 1.