NAVIGANT CONSULTING

Navigant Consulting (PI) LLC
98 San Jacinto, Suite 900
Austin, TX 78701
o. (512) 493-5400
f. (512) 472-7721

December 15, 2008

Mr. Juan Garza
General Manager
Pedernales Electric Cooperative, Inc.

Enclosed is a copy of the Report of Investigation prepared by Navigant Consulting (PI) LLC.

Sincerely,

Todd K. Lester
Navigant Consulting (PI) LLC

Enclosure
Cox Smith Matthews Incorporated

Pedernales Electric Cooperative, Inc.

Report of Investigation

By

Navigant Consulting (PI) LLC

Counsel
Cox Smith Matthews Incorporated

December 15, 2008

Introduction

Navigant Consulting (PI), LLC ("Navigant Consulting"), a subsidiary of Navigant Consulting, Inc., submits this Report of Investigation ("Report") to Mr. Juan Garza, General Manager of Pedernales Electric Cooperative, Inc. ("PEC" or "Cooperative"). In accordance with the scope of work and terms of Navigant Consulting's engagement letter with Cox Smith Matthews Incorporated ("Cox Smith"), on behalf of PEC, this Report presents the work performed in connection with the investigation, including the observations and findings of our work, as well as recommendations to address certain conditions existing at PEC during the period under investigation. It is our understanding that the Report will be presented to PEC's Board of Directors ("Board"), and disclosed to the general public.

Navigant Consulting has made its best effort, given the available time and resources, to conduct an impartial, independent and extensive investigation of various issues covering a ten-year scope from January 1, 1998 through December 31, 2007 as requested. This Report explains the substance of the most significant questions, transactions, and issues investigated during our work, including the financial, operational, management oversight, and corporate governance issues that were raised in connection with PEC's activities during the relevant period.

While the scope of our investigation has been broad, we did not conduct an exhaustive investigation into all aspects of PEC's business or all of PEC's individual transactions over the past decade, as such an investigation would require time and resources beyond those reasonably required to address PEC's significant issues. We were not asked, and we have not attempted, to perform a detailed investigation into the operations in each of the Cooperative's various districts, nor the numerous business judgments and external factors that may have contributed to management decision-making in these areas. In addition, many questions currently part of public discussion – such as questions relating to the applicable regulatory environment for electric cooperatives – are beyond the scope of our efforts in this investigation and this Report.

Certain limitations on the information available to Navigant Consulting constituted constraints on our investigation. We had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former employees, and current and former Directors, who played substantial roles in one or more of the areas under investigation, declined to be interviewed. Other limitations exist due to both the intentional and inadvertent destruction of potentially relevant hard-copy and electronic information. In addition, one open item remains in the investigation involving certain payments where our preliminary findings have warranted a more in depth review and evaluation. Although we believe the Report to be both comprehensive and accurate as based on the information available to us, information from these sources could affect our conclusions.

The Executive Summary is based on the set of facts, explanations and limitations described in the Report, and should be read with the Report itself. Standing alone, it does not, and cannot, provide a full understanding of the facts and analysis underlying our conclusions. In addition, while the Report itself is intended to provide the relevant basis for our findings, it does not exhaustively detail all of the efforts undertaken by Navigant Consulting.

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XXIX. EXHIBITS

I. Executive Summary

Upon request by Mr. Juan Garza, and under the supervision of the Public Utility Commission of Texas ("Public Utility Commission"), Navigant Consulting (PI) LLC ("Navigant Consulting") conducted an independent internal investigation into various allegations of corporate abuses and potential wrongdoing at PEC. Many of the issues investigated were raised pursuant to a lawsuit filed in May 2007 by certain members of the Cooperative, which was targeted primarily at the former General Manager and Board President of the Cooperative, as well as certain current and former members of PEC's Board of Directors.

In accordance with the scope of work and terms of Navigant Consulting's retention, the attached Report, including this Executive Summary, sets out the work performed by Navigant Consulting in connection with the investigation, including the observations, findings, and recommendations resulting from our work.

A. Background

PEC is a private, non-profit corporation organized in 1938 with the purpose of providing reliable, low-cost electric service to its members. PEC is organized as a cooperative under the Texas Electric Cooperative Act and began operations in 1939.

Headquartered in Johnson City, Texas, PEC is an electric distribution cooperative that currently serves over 226,000 members (i.e., meters) in a 24-county, 8,100 square-mile non-contiguous service area in central Texas. PEC's service area includes part or all of over 40 municipalities, including more than 15,000 miles of energized line and 300 miles of transmission line. With annual revenues over $450 million and total assets exceeding $1.1 billion, PEC is the largest electric cooperative out of over 900 member-owned electric cooperatives in the United States.[1]

On May 16, 2007, a lawsuit was filed in Travis County District Court on behalf of certain members of the Cooperative (seeking class action status) against PEC and PEC's Board and management ("class action lawsuit"). The class action lawsuit made various allegations including that PEC's Board and management had breached their contractual and fiduciary duties, and were negligent in the management of PEC's operations over the years. It was principally focused on alleged corporate abuses related to the compensation, benefits, and expense practices of the Board and management, as well as on the ongoing funding of a wholly-owned subsidiary, Envision Utility Software Corporation ("Envision"), and PEC's policy regarding the retirement or return of member patronage capital (i.e., capital credits).[2]

Aspects of the class action lawsuit and the substantive media and public attention that followed focused on the then-current General Manager of PEC, Mr. Bennie R. Fuelberg, and the Board

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1 Pedernales Electric Cooperative, Inc. Annual Report 2007.

2 Plaintiff's Original Petition - Lee Beck Lawrence, individually, and as a representative of all others similarly situated v. Pedernales Electric Cooperative, Inc. et al., Cause No. D-1-GN-07-001434.

President, who was also a full-time employee of PEC, Mr. W.W. "Bud" Burnett. At the time the class action lawsuit was filed, Mr. Fuelberg had served as the General Manager of PEC for over 30 years and Mr. Burnett had been a member of PEC's Board of Directors for over 40 years. In addition, many Directors at that time had long-standing histories on PEC's Board.

Messrs. Fuelberg and Burnett resigned in early 2008.[3] Mr. Juan Garza was selected by the Board to replace Mr. Fuelberg as General Manager. Mr. Garza had been General Manager of Austin Energy, the City of Austin's municipally owned electric utility, and had held prior positions in municipal administration. Mr. Garza's tenure as General Manager began February 11, 2008.

B. Scope and Objectives of the Investigation

A condition required by Mr. Garza in connection with his retention, was that he be delegated authority from the Board to retain independent counsel and an investigative consulting firm to conduct an independent and comprehensive investigation into past activities at the Cooperative in connection with the alleged abuses. Mr. Garza retained Cox Smith to provide independent legal advice and assistance in connection with the investigation. Cox Smith in turn engaged Navigant Consulting to provide forensic investigative and information technology consulting services.

Navigant Consulting's retention to perform the forensic investigation was memorialized on March 10, 2008, when a settlement agreement was reached between the parties in the class action lawsuit. One of the agreed upon terms in the settlement was the performance of an "independent internal investigation" of PEC by Navigant Consulting covering a period of ten years from January 1, 1998 through December 31, 2007. The settlement was approved by the presiding judge in the case on May 5, 2008, but was subsequently appealed by several parties. As of the date of this Report, one of the appeals is still pending.

One of the objectives of the investigative team's efforts has been to address the many questions and concerns expressed by the Cooperative's members, the media and various public officials. As a part of the investigation, Navigant Consulting performed a comprehensive independent review of various PEC transactions, business processes and expense items, as well as new areas identified during the course of the investigation. Navigant Consulting was also requested to provide certain business process improvement consulting services to PEC. These services included evaluating observed processes and behaviors in relation to those of best performing electric utilities and to provide recommendations to PEC on a prospective basis.

At all times during the investigation, Navigant Consulting has remained independent of the Cooperative, its Board and management, as well as of the various parties involved in the class action lawsuit and litigation process. In addition, in an effort to ensure a new spirit of openness and transparency in PEC's operations, as well as to promote public confidence in the investigative process, Mr. Juan Garza, at the request of Senator Troy Fraser and Representative Patrick Rose, made

[3] Mr. Burnett resigned his position as Coordinator with Pedernales Electric Cooperative, Inc. in late 2007. He continued serving as a member of Pedernales Electric Cooperative, Inc.'s Board until early 2008.

a request to the Public Utility Commission to provide oversight in the direction of the independent investigation conducted by Navigant Consulting.

The Public Utility Commission was tasked with ensuring that a thorough and complete investigation was conducted and providing assurance that Navigant Consulting's efforts, and the resulting report, were not subject to any improper influence by either PEC management or the Board. A team of professionals from the Public Utility Commission was integrally involved in monitoring, evaluating, and providing input into the work steps performed by Navigant Consulting during the investigation, as well as providing their knowledge and expertise to help identify areas for potential improvements in PEC's operations.

C. Work Performed

Navigant Consulting received the full cooperation of PEC and its current employees during the course of the investigation. PEC employees have worked diligently to provide information requested by Navigant Consulting.

The information provided in the Report is based on our review, analysis and evaluation of numerous electronic and hard-copy files, documents and other information. We also conducted numerous discussions and interviews with current and former employees, including current and former Board members. In addition, we have relied upon our collective expertise and experience in conducting investigations of a similar nature, as well as our extensive knowledge, experience and expertise in the electric utility industry in reaching our observations and findings.

As part of this Report, we have made a number of comparisons and assessments using appropriate data from the electric utility industry, including useful data available from the National Rural Electric Cooperative Association ("NRECA"). Nevertheless, we have not attempted to cross-reference existing or recommended practices on all the issues investigated with those practices established by NRECA for its member entities. NRECA's policies and guidelines for its members constitute a significant resource for PEC as it progresses toward its goal of achieving improvements in its operations and governance that implement best practices for an electric cooperative.

During the course of the eight-month long investigation, Navigant Consulting and Cox Smith reviewed over 150,000 pages of hard copy documents and files, including information provided through the class action lawsuit and documents produced at our request from various departments within PEC. In addition, members of the investigative team had full access to the electronic records available at PEC. We identified and reviewed approximately 25,000 e-mails and 23 Gigabytes (GB) of potentially relevant electronic user files from computers, computer networks and network backup tapes (approximately 1.3 million pages of information). We also identified and reviewed over 125,000 transactions from a variety of general ledger accounts including various administrative and general expense accounts.

Over 80 individuals were interviewed throughout the course of the investigation including current and former employees of PEC, as well as current and former Board members, many of whom were interviewed more than once. All of the persons interviewed were cooperative and generally forthcoming with information.

However, certain former employees, and current and former Directors, who played substantial roles in one or more of the areas under investigation, declined, through Counsel, to be interviewed. Two of the individuals who declined to be interviewed are the former General Manager, Mr. Fuelberg, and the former Board President, Mr. Burnett.

During the course of our investigation we learned that certain hard-copy files and electronic information (including e-mails) were apparently destroyed. Our inquiries and investigation into the missing information have led us to conclude that while certain information was inadvertently lost, other hard-copy and electronic information and data appears to have been intentionally destroyed. The data in question includes electronic information that was resident on several laptop computers in the former General Manager's possession, and certain hard-copy files that were being maintained under his direction and control.

It has not been determined whether the missing materials contained important information. However, based on our experience in other investigations, it is likely that certain of the hard-copy and electronic information contained information that would have been relevant to our investigation and the ultimate conclusions expressed in this Report. Details regarding the apparent destruction of evidence were communicated to the appropriate parties during the investigation, including the Blanco County District Attorney and the Office of the Attorney General of Texas.

D. Summary Observations and Findings

The investigation focused on reviewing the management and operations of PEC during the previous ten years while under the direction of the former General Manager, Mr. Bennie Fuelberg. While many questions and concerns have focused on issues of compensation, benefits and expenses, the investigation expanded beyond these areas.

The central issues identified during the investigation include: 1) the management practices, decision-making and authoritarian management style of the former General Manager, 2) the conduct of PEC's Board, 3) the compensation, benefits and expense reimbursement of employees and Board members, 4) related party transactions and potential conflicts of interest, and 5) various payments to third-parties. Based on our work to date we have concluded that PEC was managed for many years with limited oversight, engaged in questionable transactions, and had significant deficiencies in its internal control structure and control activities.

The primary source of the issues identified at PEC resulted from past deficiencies in both governance and management. The governance structure of the Cooperative appears to have been static for more than 20 years, and although recently improved in several respects by PEC's new management, is in need of additional reform. The past relationship between the Board and the former General Manager and Board President was contrary in many respects to principles of effective oversight. At a time when organizations are expected to operate with increasing transparency, the operations of PEC, and especially the actions of Mr. Fuelberg and the former Board President, were secretive and closed.

It would nevertheless be unfair to characterize many of the operational and management practices of the Cooperative in the last ten years as unsuccessful. The Cooperative has grown significantly over the years to become the largest electric cooperative in the United States, and in many respects, significantly larger than most other cooperatives across the country. PEC has faced significant challenges in addressing this growth including substantive demands on its infrastructure and ability to continue providing reliable and competitively priced service to its customers. PEC's successes in this regard are evident given the Cooperative's top-ranked customer satisfaction and electric reliability over the past several years.

However, PEC's growth, coupled with the management style and practices of the former General Manager, and those around him with significant control over the Cooperative and the Board, have not come without costs. In some respects, Mr. Fuelberg's vision for the Cooperative and his management style are responsible for the noted successes and high-customer satisfaction rankings of the Cooperative, but those successes belie various problems. The same management practices presided over a Cooperative where budgets and effective cost control were essentially nonexistent, expense controls were lax, where effective internal controls and control activities were limited in many respects, and where employee discontent over abusive management practices appear to have been significant.

Throughout the course of the investigation, we identified many examples of questionable management practices, serious deficiencies in certain areas of the Cooperative's internal control environment and control activities, and a general lack of openness and transparency across various aspects of the Cooperative's operations and business practices. The more notable observations and findings resulting from Navigant Consulting's work are summarized below:

Former Management Practices

A central focus of the investigation was in relation to allegations regarding the management practices of the former General Manager and his failure to operate the Cooperative in a prudent and financially responsible manner, and for the benefit of the Cooperative's members. Mr. Bennie R. Fuelberg was the long-standing General Manager of the Cooperative and had served in that position for over 30 years before his resignation in March 2008. Mr. W.W. "Bud" Burnett was also a central figure in PEC's management, serving in a dual role as an employee of the Cooperative with the title of Coordinator, and as Board President. Mr. Burnett served as Coordinator for over 20 years and as a member of PEC's Board for nearly 40 years.

As General Manager for over 30 years, Mr. Fuelberg had in-depth knowledge into most aspects of the Cooperative's business and he exercised significant control and discretion over the operations and decision-making. His management style was described as extremely hands-on and controlling, as well as authoritarian in nature. Throughout his tenure, PEC's focus was centered on customer satisfaction, but often at the expense of tighter fiscal controls. With an emphasis on service and reliability, regardless of cost, the former General Manager fostered management practices at PEC where cost controls, budgets and expense management were secondary.

Internal controls are systems of policies and procedures that support reliable financial reporting, promote compliance with laws and regulations, and achieve effective and efficient operations.[4] However, various aspects of PEC's internal controls have been deficient in their ability to support these objectives for a number of reasons. PEC does not make use of budgets or associated variance reporting in comparison to actual performance. In addition, PEC historically performed only limited benchmarking to comparable entities or the tracking of various financial performance metrics, and has structural constraints on effective functional reporting by department or district due to limitations in its general ledger chart of accounts; all of which hindered the effective identification, implementation and monitoring of effective business practices across the Cooperative's various departments and districts.

With the exception of the former General Manager and two Assistant General Managers, who appeared to have possessed limited decision-making responsibility and authority, there was a noticeable lack of other senior or executive management at the Cooperative. Normally, the chief financial officer, in-house general counsel, and internal auditor serve in "gatekeeper" roles by monitoring the compliance of senior management with applicable laws and regulations, policies and procedures, and other internal financial controls. However, these roles were essentially absent from PEC.

Throughout our efforts, we identified various concerns and deficiencies in the management practices at PEC that had a significant impact on the culture and control environment of the Cooperative. PEC's organizational structure, combined with significant segregation of duties into various departments and limitations on interdepartmental control functions, resulted in an environment where the former General Manager, and no other, had primary responsibility for monitoring many of the Cooperative's systems of controls. This Reporting structure allowed the former General Manager to easily override controls if desired.

Board of Directors Governance

The former General Manager appears to have effectively controlled many aspects of the Board, rather than the other way around. While many of the actions of the Board appear generally to have been taken with the goal of serving the interests of the Cooperative, at times it appears the Board subordinated its responsibilities and failed to exercise independent judgment in safeguarding the Cooperative's assets and protecting the interests of its members. While the Cooperative achieved some noteworthy successes during Mr. Fuelberg's tenure, including recognition for its customer satisfaction and maintenance of reliable service, the Board's consistent reliance on Mr. Fuelberg's initiatives in major policy areas and its willingness to allow him to assume substantive control over the Cooperative's decision-making placed the Cooperative and its members at risk and resulted in a disruptive controversy.

The Board appears to have placed almost complete reliance in the former General Manager to set the strategic direction of the Cooperative, adopt the policies and procedures by how it was governed,

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[4] The Committee of Sponsoring Organization's of the Treadway Commission (COSO), *Internal Control – Integrated Framework*, 1992.

and provide the benchmarks for how it was to be measured and evaluated. Mr. Fuelberg appears to have effectively controlled the Board members through limiting their access to information, controlling the items brought before them, setting a tone of intimidation under which Directors felt unable to effectively communicate their opposition, and through his control of the former Board President, who was also an employee of the Cooperative.

The effects of the deficiencies in Board oversight were allowed to continue through a Board election process that effectively preserved the status quo; and one that also appears to have been primarily controlled by Messrs. Fuelberg and Burnett, as well as A.W. Moursund, the Cooperative's former outside General Counsel.

The tenure of the former General Manager is characterized by various efforts to direct the Cooperative into costly ventures, most of which were outside of its core business activities, including the creation of the Texland Electric Cooperative venture (1979), the Cooperative's acquisition and support of Envision Utility Software Corporation (1990 – present), the acquisition of Kimble Electric Cooperative, Inc. (2000), and most recently the creation of the Texas Skies internet related services venture (2006). PEC incurred significant losses in relation to these pursuits. While these investments may have appeared to be strategic at the time, each of the ventures appears to have been initiated without adequate due diligence or clear objectives, and appear to have been operated without financial budgets and controls, and with apparent disregard for either the interests of the members or the Board's role in setting the strategic direction of the Cooperative.

The operating environment at PEC was characterized as one in which Cooperative employees, as well as the Board, felt unable to significantly challenge the decisions of the former General Manager, and where management directives of "don't ask" and "do what you're told" appear to have been common. It appears the former General Manager effectively isolated the Board and everyone else in the Cooperative from having any meaningful oversight. In short, no one was minding the store except the General Manager, and no one was minding the General Manager.

Envision Utility Software Corporation ("Envision")

Envision's foCIS software product serves as the primary platform for the Cooperative's customer information management and billing system, and appears to be functionally equivalent to similar software solutions provided by some of the industry's leading software providers. However, PEC's sole funding of the development of the software, as well as Envision's continuous efforts to market the software for sale to outside parties, has been costly and detrimental to the Cooperative over the years. From 1990 through 2007, PEC has incurred nearly $70 million in costs related to the development of the foCIS software product and the ongoing maintenance and support provided by Envision. PEC's continuing costs to support Envision are ratably higher than average costs incurred by other comparable cooperatives and electric utility providers, a fact that necessitates urgent action by PEC to bring these costs back in line with industry norms.

Texland Electric Cooperative, Inc. ("Texland")

The Texland Electric Cooperative functionally ceased to exist in the late 1980's, after more than $18 million in expenditures had been incurred by both PEC and Bluebonnet Electric Cooperative, Inc. in connection with a failed attempt to develop an electric generation facility as an alterative to their existing wholesale power supplier, the Lower Colorado River Authority ("LCRA"). While PEC ultimately appears to have recouped much of its investment in the venture through an agreement with LCRA, a bank account in Texland's name was discovered during the investigation with a balance in excess of $565,000. The bank account was not listed in PEC's books and records.

The circumstances surrounding the existence of the bank account, its location at Cattleman's National Bank – a bank principally owned by the Cooperative's former outside General Counsel – and the fact that Messrs. Fuelberg and Burnett remained as signatories on the account, raised significant questions during the investigation regarding the potential for impropriety. While the source of the funds has been determined, and efforts are underway in the courts to establish PEC's interest in the funds, PEC's Board appears to have had little or no knowledge of the bank account or the fact that significant sums of money were paid from the account to Messrs. Fuelberg, Burnett and Moursund in 1987 and 1988.

Kimble Electric Cooperative, Inc. ("Kimble")

The acquisition of Kimble Electric Cooperative (Kimble) in 2000, a 5,000-meter rural electric cooperative in West Texas, appears to have been completed with limited or no due diligence and without effective analysis, debate or deliberation by PEC's Board. The costs paid for Kimble, combined with PEC's ongoing costs to provide service to its customers in the former Kimble region, are high. While various strategic motives for the Kimble acquisition have been assigned to the former General Manager, as with the other ventures, the costs to date have far outweighed the perceived benefits of the acquisition.

Wild Texas Blue, Inc. (d/b/a "Texas Skies")

Texas Skies was a short-lived venture by PEC to offer internet service to its rural members. Incorporated in 2006, Texas Skies lasted a little over a year before operating constraints resulted in its inability to enroll new subscribers. At the time, Texas Skies had fewer than 400 subscribers. Texas Skies was sold in May 2008. Net of the sale proceeds, PEC booked a loss of approximately $640,000.

In many respects, the management practices surrounding the ventures described above were indicative of the overall guarded and controlling nature of the former General Manager, as well as his focus on expanding the Cooperative, and its business activities, at times with apparent disregard for the overall costs to the Cooperative's members. While some of these ventures, if successful, might have provided benefit to the Cooperative's members, few due diligence efforts were undertaken to realistically assess the prospects for such success.

Operational and Financial Management

During the period under investigation, the Cooperative managed a significant and sustained rate of growth that was much greater than most other cooperatives and municipal utilities during the same time period. Mr. Fuelberg's customer-centered culture at PEC, under which the customer always came first, accounted for much of this success, though frequently to the detriment of more fiscally responsible management.

While the Cooperative maintained relatively competitive electric rates, its rate competitiveness appears to have been at the expense of greater debt and reduced equity. In contrast to ten years ago, while the Cooperative is much larger, its financial condition deteriorated throughout much of the period before being stabilized by substantive net margins in 2006. While the Cooperative's cost of power, relative to its total revenues, appears to have remained relatively constant over the past ten years, its controllable expenses, and especially administrative and general expenses, have increased significantly relative to total revenue. With the exception of a questionable, but apparently accepted, change in accounting practice by the Cooperative in 1997, the Cooperative's equity, relative to its total debt, was in decline for much of the period under investigation. Absent the referenced significant net margin in 2006, the Cooperative's financial position would have been much worse.

The financial management practices of the Cooperative over the past ten years contributed to the strains on PEC's equity level and significantly influenced the Cooperative's decisions not to return capital credits to its members. In many respects, the Cooperative has been managed primarily with respect to its revenues, and with little apparent attention to its costs.

Patronage Capital ("Capital Credits")

The Cooperative's decision to not return capital credits to its members over the years raised significant concern among the Cooperative's members and was a central issue in the class action lawsuit. In reality however, the Cooperative's financial condition did not warrant the payment of capital credits during the relevant periods. Despite the existence of a large balance of member or patronage capital recorded on the Cooperative's books, over the years the Cooperative's level of equity (i.e., the amount of capital invested by the Cooperative's members and a significant source of capital for the Cooperative to fund future growth) appears to have been inadequate to pay capital credits. Based on various guidelines and accepted financial ratios, including the Cooperative's internal guidelines, as well as restrictions by the Cooperative's lenders and bondholders, the Cooperative was not in a position to return capital credits without detriment to its already low equity ratio, absent the necessity of raising rates or using debt to fund such capital credit payments.

The Cooperative's financial condition, and its inability to pay capital credits, is a reflection of the financial management practices of the former General Manager. While the primary factors that influence a Cooperative's net margins are the Cooperative's wholesale cost of power and its ability to recoup that cost, as well as other costs, through the electricity rates charged to its members, there are significant expenses (i.e., controllable expenses) that are influenced directly by the management practices of the Cooperative. PEC appears to effectively have been able to pass on increases in its cost of power to its members, yet PEC's controllable expenses have increased significantly over the past ten years.

For many years PEC's net margins appear to have been insufficient to build, or even maintain, equity relative to its significantly increasing debt during the same period. Throughout this time, rather than focusing on controlling costs, the Cooperative appears to have operated with few restrictions or limits on the various types of controllable expenses incurred by the Cooperative, including expenses incurred by former Senior Management and the Board.

Director Compensation and Benefits

During the period 1998 – 2007, average compensation per Director, as well as total Director compensation and benefits costs, more than doubled, with a significant portion of that increase occurring in 2001 following a change in the Board's compensation policy and the addition of a fixed monthly fee of $1,500 per month. In 2007, PEC's average total compensation per Director was approximately $50,000 per year, which significantly exceeded the average compensation of Directors at most other cooperatives surveyed. Accounting for significant differences in size between PEC and other cooperatives, PEC's average total compensation per Director was still 20-30% higher than the median total compensation of the other cooperatives surveyed.

The Board also had a practice of designating certain retired Directors to be either Honorary or Emeritus Directors in recognition of past service to the Board, who in total received in excess of $100,000 during the same period. PEC also continued to compensate the former Board of the Kimble Electric Cooperative acquired by PEC in 2000, which amounted to in excess of $311,000 over a four and half year period.

During the period under investigation, PEC held multiple Board meetings per day on at least two to three different days throughout each year. PEC's practice was to reimburse each Board member in attendance for a separate per-meeting fee for each meeting attended. As an example, on occasions where the Board held two meetings in one day, the Board members would be paid $1,500 (i.e., two $750 per meeting fee payments). The additional per meeting fee payments are estimated at close to $400,000.

We also identified the use of a separate bank account by the former General Manager for making contributions to various political candidates and organizations. The contributions appear to have been made on behalf of each individual Director. The bank account was apparently funded by individual contributions from PEC Directors, usually once or twice a year. However, the dates of the observed deposits in the bank account appear to coincide with some of the observed dates of the multiple meetings held by the PEC Board. At least one Director confirmed that the two were related.

From 1998 - 2007, the total compensation and benefits provided to PEC's Board, Honorary, Emeritus and retired Directors, as well as the Kimble Board, were approximately $6,283,000. This was due in part to both the higher average amount of compensation paid to PEC's Board, as well as the large number of Directors (i.e., seventeen) on PEC's Board.

In many respects, a Board governing the size and complexity of a corporation like PEC would be expected to expend a significant amount of time in addressing the Cooperative's needs and in return would be fairly compensated. However, as described in this Report, the Board's role in governing the Cooperative during the period evaluated appears to have been largely passive, with the Board effectively subordinating much of its policy and decision-making to the former General Manager, Mr. Fuelberg.

Director Expenses and Expense Reimbursement

PEC's Board was routinely reimbursed for expenses incurred by them on behalf of the Cooperative, as well as expenses that were incurred and paid for directly by PEC. During the period under investigation, Director expenses totaled almost $1.9 million, with a majority related to various travel related expenses including airfare, lodging, and meals, as well as registration related fees for various conferences and meetings attended.

During the course of our investigation, we did not identify any formal Director expense policy or even informal/ad hoc rules or guidelines regarding the amount and appropriateness of expenses that could be incurred by, or on behalf of, the Board. In addition, there appear to have been no predetermined spending limits or ranges, nor established per diem rates to set a benchmark for reasonable and necessary expenditures.

In addition to the lack of a defined expense policy, PEC had virtually no requirement for expenses to be authorized in advance or approved when submitted, or any apparent Board review and/or audit function for questioning expenses incurred by the Directors.

The vast majority of expenses reimbursed to Directors, or paid on their behalf, appear to have been in relation to various meetings, conferences, and workshops attended by the Directors. Many of the expenditures questioned as potentially excessive appear to have been primarily controlled and paid for by PEC on the Directors' behalf. In many respects, it appears that the Directors simply followed the lead established by the former General Manager. However, while business-related explanations appear to exist for most of the expenditures analyzed, in reality the expense practices at PEC and on behalf of the Board went largely unchecked.

While most of the decisions regarding expenses for higher-end hotels, airfare and group meals at higher-end restaurants, as well as Celine Dion concert tickets, appear to have been decisions orchestrated by the former General Manager, and not the Board, the Directors were willing participants and the beneficiaries of many of these expenditures.

The Board has the authority and the obligation to make and adopt rules for the management, administration and regulation of the business affairs of the Cooperative, including an obligation to provide meaningful oversight and to implement controls to ensure that expenditures do not exceed levels that are in the best interests of the Cooperative's members. However, the Board's oversight in this area during the period under investigation was largely absent.

Former Senior Management Compensation and Benefits

During the period under investigation from 1998 – 2007, the total compensation and benefits received by Messrs. Fuelberg, Burnett and Dahmann ("former Senior Management") exceeded $9.7 million. Mr. Fuelberg's portion of that amount was in excess of $6.3, million including a $375,000 sign-on bonus for executing a retention agreement with PEC in 2004, and over $1.5 million in deferred compensation paid in 2007 and 2008.

Outside of the deferred compensation and sign-on bonus, the most substantive changes to Mr. Fuelberg's compensation occurred in the 2001 – 2002 time period when Mr. Fuelberg's salary effectively doubled from $184,704 per year as of July 2001 to $350,000 per year as of September 2002. The increase in Mr. Fuelberg's compensation included a Board approved resolution to increase the monthly salary of Messrs. Fuelberg and Burnett, as well as the retainer paid to the Cooperative's outside General Counsel, Mr. A.W. Moursund, by $5,000 per month, which was described as payment to replace, and in lieu of, the semi-annual bonus payments received by each.

The former Board President, Mr. Burnett, was compensated as a full-time employee of the Cooperative for almost twenty years. He originally became a full-time employee of the Cooperative in 1987 with a starting annual salary of $60,000.[5] At the time of his retirement, Mr. Burnett was being paid an annual salary of $195,790.

While it was generally understood that Mr. Burnett's job description was to act as a liaison with various governmental and legislative individuals and entities, neither the Board nor various PEC managers appear to have had much understanding of what Mr. Burnett did on a day-to-day basis. With no office or effective presence at the Cooperative, Mr. Burnett's actual duties were unknown to most within the Cooperative. Various current and former PEC employees and Board members have been critical of Mr. Burnett's level of compensation, which even many Board members believed to be much lower than its actual level.

The Board's failure to take steps to substantively evaluate the performance of Mr. Burnett as a manager reporting directly to them, or indeed to assess the utility to the Cooperative of his function, as well as to insist on accurate information about and to critically evaluate Mr. Burnett's compensation, is an example of the Board's failure to provide effective oversight of Mr. Fuelberg and of the Cooperative. As with a number of other issues, the Board allowed decisions on these matters to be made by the former General Manager, Mr. Fuelberg, without substantive input from the Board, and acceded to a status quo that was not in the best interest of PEC or its members.

In some respects, Mr. Fuelberg's, as well as the Board's compensation decisions, appear to have been motivated more by cash-on-hand in the Cooperative than by any objective measure of performance or comparison to industry-wide compensation benchmarks. Significant increases in Mr. Fuelberg's compensation over the years, as well as certain increases in the Board's compensation, increases in employee wages and bonuses, and even increases in the Cooperative's contributions to its retirement

[5] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 17, 1987.

plan, appear to correlate closely with the Cooperative's bond offerings and the receipt of funds through the bond proceeds and the issuance of debt.

While the pre-2008 Board members generally acknowledge and continue to defend the amounts paid to Mr. Fuelberg, we have identified limited empirical evidence used by the Board in justifying its decisions. In each year reviewed, there does not appear to have been any evaluation body, such as a Compensation Committee, tasked with identifying, analyzing and evaluating the appropriate compensation for Messrs. Fuelberg and Burnett, nor the establishment of any objective means of evaluating performance against the proposed compensation.

Former Senior Management Expenses and Expense Reimbursement

We identified almost $900,000 in expenses incurred by Messrs. Fuelberg, Burnett and Dahmann during the period under investigation. In addition to the lack of defined spending limits or guidelines, former Senior Management expenses appear to have been subject to virtually no Board review and no effective audit function. In effect, no one reviewed or ever questioned expenses incurred by the former Senior Management. We were told that Mr. Fuelberg's dictum was that if the credit card statement or expense voucher was signed by a manager, then the Finance Department had no reason to review or question the expense. Consequently, the Finance Manager and his department were relegated to the role of merely processing the expenses and payments.

While PEC had certain expense and travel reimbursement guidelines, the policies provided little guidance as to what costs were considered to be reasonable and necessary in relation to Cooperative business travel.

Mr. Fuelberg incurred substantial expenses through his credit card and the expense voucher process, routinely traveling on business and first-class flights, staying at expensive hotels, hosting large dinners at expensive restaurants (albeit often for PEC Directors or in other business contexts), and purchasing Godiva chocolates for distribution at the office. Mr. Fuelberg exercised sole discretion in determining which expenses he incurred were to be paid or reimbursed by PEC. We were told that Mr. Fuelberg also encouraged business and first-class airfare travel for certain of his employees, as well as the Board, and encouraged spousal travel citing that "this was a perk" at PEC.

As with most organizations, the tone for PEC's expense reimbursement policy was set at the top by Mr. Fuelberg with regard to what was considered a reasonable and necessary business expense versus what might have been considered excessive. Under the tone established by Mr. Fuelberg, there appear to have been few limitations on what was considered an acceptable expense. Based on our review of credit card expenditures by the entire Cooperative during the period under investigation, this tone apparently translated into a credit card and expense reimbursement process where others likewise failed to exercise the type of restraint that might be considered prudent for a member-owned Cooperative.

While certain questions exist as to travel expenses incurred by Messrs. Fuelberg and Burnett, the majority of the expenses incurred by former Senior Management appear to have been incurred in relation to various sponsored conferences and meetings that were attended by former Senior

Management and often by certain members of the Board. While the expenses incurred for business and first-class travel raise questions as to their propriety, there were no express policies precluding either former Senior Management or the Board from traveling by business or first-class airfare, nor were there limitations on the higher-end hotels typically selected by Mr. Fuelberg, or the many large group meal expenses typically incurred in relation to Directors' workshops and managers' retreats.

IRS Form 990 Disclosures

Electric cooperatives exempt from taxation under section 501(c)(12) of the Internal Revenue Code are required to file a Form 990, Return of Organization Exempt From Income Tax ("Form 990").[6] Form 990s are used by tax-exempt organizations to provide information required by section 6033 of the United States Code, including items of gross income, receipts and disbursements, and other information about the organization's finances and operations.[7] Part V of this Form requires disclosure of compensation paid to certain "key employees" including the senior executives of the entity.

In connection with its submittal of the Form 990 during the period 1998 – 2005, PEC did not identify Mr. Fuelberg as a key employee and hence did not report relevant information for the former General Manager, including his compensation, in Part V of the Form 990. Based on our review of the pertinent information, it appears that PEC should have included the former General Manager as a "key employee" under the definition applicable during the period 1998 – 2005. It is our understanding that PEC's failure to include the proper information was primarily at the direction of Mr. Fuelberg. We were told by PEC's current CFO that PEC consulted with KPMG regarding PEC's decision of whether or not to include Mr. Fuelberg as a key employee on the Form 990.

Related Parties - Moursund Family Interests

Of concern during the course of the investigation was the extent of certain related and other affiliated party relationships existing within the Cooperative, apparently in plain view of the Board. Chief among these was the relationship between PEC and the Moursund family. We believe numerous potential conflicts of interest existed with respect to the various services provided by the Moursunds to PEC over the years. The potential for conflicts of interest, or perceptions of such conflicts, should have raised serious issues for the Board in its service of a cooperative funded primarily by member contributions.

A.W. Moursund served as General Counsel for the Cooperative for many years, as both a full-time employee (1951 – 1984) and as an outside service provider through retainer (1984 – 2002). A.W. Moursund's role as General Counsel was effectively passed to his son, Will Moursund, and the family law firm, Moursund, Moursund & Moursund ("Moursund Law Firm") following Mr. Moursund's death in 2002. In addition, PEC also received services over the years through various Moursund controlled business interests including Cattleman's National Bank ("Cattleman's") and the

[6] Instructions for Form 990 and Form 990-EZ, p. 1, 4. 2007.

[7] United States Code TITLE 26 - Subtitle F - CHAPTER 61 - Subchapter A - PART III - Subpart A - § 6033 Returns by exempt organizations.

Moursund Insurance Agency, among others (collectively referred to as the "Moursund-related entities"). It is estimated that the Moursund related individuals and entities received in excess of $4 million over the past twenty years from their affiliation with PEC.

Both current and former members of the Board, as well as PEC managers, admitted knowing through personal knowledge that Cattleman's bank was owned by the Moursund family; that certain PEC Directors sat on the Board of Cattleman's bank; and that Mr. Fuelberg had once sat on the Board of Cattleman's. However, there was no systematic briefing of, or review and approval by the Board of potential conflicts. It has also come to our attention that various current and former Directors, and potentially former management, had, and may still, have limited ownership interests in Cattleman's bank. PEC nevertheless utilized Cattleman's as a primary depository for over 20 years.

A.W. Moursund had significant influence over the Cooperative for many years. That influence is evident in both the compensation he received and the fact that the PEC Board members and others overlooked apparent conflicts of interest arising from various business relationships between PEC and the Moursund-related entities, while at the same time Mr. Moursund served PEC as actual and *de facto* General Counsel.

As with former Senior Management, no apparent mechanism existed to establish standards for gauging the appropriateness of the compensation A.W. Moursund received, the business expenses incurred on his behalf, or the business relationships he fostered, including those that presented apparent conflicts of interest. Likewise, the Board never instituted a conflicts of interest questionnaire or policy, which is considered a fundamental good governance practice for most Boards, nor did it have any apparent process in place for monitoring and handling potential conflicts that might arise.

Notwithstanding A.W. Moursund's probable contributions to the Cooperative's growth and stability during the early years of his involvement with PEC, there is a general perception that A.W. Moursund and the Moursund Law Firm, as General Counsel, provided PEC with limited value in proportion to their compensation during the period under investigation.

Employee Pay/Benefits – Non-Standard Practices

We determined that approximately 25 employees participated in certain non-standard employment and/or compensation arrangements with PEC during the period under investigation. The non-standard arrangements involved employees of various employment status including active employees, retired employees, employees approaching retirement, and employees who resigned or were terminated. In most instances, employees appear not to have been providing substantive services to PEC but continued to receive compensation, as well as benefits, from the Cooperative for varying periods of time.

Some of these individuals were determined to have had severance-related agreements, while others appear to have received compensation and benefits at the continuing request of the former General Manager, and with apparent support from the Board. The typical length of period for most of the employees observed ranged from two to ten months, with two notable exceptions. A former assistant to Mr. Fuelberg, who we understand left work for medical reasons, was allowed to remain on PEC's payroll for several years until she qualified for certain retirement benefits. Another former manager, was allowed to remain on PEC's payroll at her full salary, despite transitioning to an apparent part-time basis, which also effectively allowed her to work remotely.

Third Party Service Providers

During the course of the investigation, we evaluated various outside consulting and third party providers of professional services including fees paid to various attorneys, lobbyists, and other consultants. We determined that a number of those service providers were being compensated through the use of retainers, which were paid monthly by the Cooperative, in some cases for a number of years. Many of the service providers being paid through retainer provided either no support or invoices with limited or no description with regard to the nature of the services provided. In addition, we typically did not identify formal contracts or agreements that outlined the scope of services, amount of compensation or the term of the agreements with the service providers in question.

While some of the service providers were retained through approval of the Board, the Board meeting minutes provide scant details as to what, if any, discussions occurred regarding their respective retention. In addition, while certain Directors recalled the retention of several of the service providers in question, they were surprised that some of these consultants had been receiving monthly retainers from PEC for many years.

Very few Directors or PEC managers we interviewed had knowledge of what service, if any, a number of these individuals had been providing to PEC for the years in question or the amounts of compensation paid to these individuals. Certain Directors interviewed expressed concerns about not adequately being informed of the amount of compensation paid to certain of these individuals, as well as about the former General Manager's failure to keep the Board apprised of the length of the retention.

In addition, during the investigation certain payments to Clark, Thomas & Winters ("Clark Thomas") were identified in which the supporting invoices provided limited descriptions for the purpose of the payments. Included in these are various $30,000 payments to Clark Thomas between 1998 and 2003 totaling $360,000, and a $150,000 payment in December 2004. These invoices and payments are inconsistent with the pattern and nature of other invoices and payments to Clark Thomas during the period 1998 – 2007.

PEC's management was recently informed by representatives of Clark Thomas that payments, some of which appear to be linked to these invoices, were made by Clark Thomas on PEC's behalf to Mr. Fuelberg's brother, Curtis Fuelberg, a Texas lobbyist, and to then-Director E.B. Price's son, William Price, an attorney. Navigant Consulting's inquiry into these payments is ongoing and the scope of our efforts has been expanded to include a review of Clark Thomas' invoices prior to 1998, as well as a more detailed review of its invoices during the period 1998 – 2007. Our observations and findings with regard to these payments are ongoing and will remain an open item for purposes of this Report.

Summary

Mr. Fuelberg's management practices were a significant factor in creating the problems stated above and discussed throughout the Report. Mr. Fuelberg created an authoritarian culture in the General Manager's office in which he, rather than the Board, dominated the setting of policy and strategic direction for PEC. He limited the flow of information – including discouraging and sanctioning those who disagreed with him – and limited the authority of the Board and the Cooperative's managers. The Board allowed this culture to prevail by not providing sufficient oversight of Mr. Fuelberg and the operations of PEC.

The resignation of the Cooperative's former General Manager and of two key employees, as well as certain members of the Board has not, by itself, fully remedied the problems at PEC. While PEC appears to continue to provide reliable and competitively priced service to its customers, PEC must correct the underlying deficiencies in its organizational structure, decision-making processes, and internal controls. The current situation presents PEC with an opportunity to bring its management and Board in line with best practices and to revamp the fundamental operations of the Cooperative and its Board. We believe the identified issues in this Report can be resolved if the Board and the new General Manager commit sufficient time and resources to addressing PEC's various issues.

The investigative team recognizes that both the new General Manager, Mr. Garza, and the Board already have begun this process by developing and implementing an initial set of reforms. PEC is in the process of a major governance transition, including a significant change in management. We understand that PEC has: 1) adopted many new governance resolutions and policies, 2) terminated various questionable related-party and third-party relationships, 3) developed a transition team to integrate the Envision subsidiary into the Cooperative, 4) started to critically analyze certain operational concerns, 5) enhanced the internal governance structure through the creation of various senior executive positions that had not previously existed (i.e., CFO, General Counsel), and 6) is in the process of developing an internal audit function within the Cooperative. We believe that each of these steps is necessary and prudent.

The problems at PEC are not unique. As regulatory authorities, the media and numerous lawsuits have pointed out in recent years, similar problems have been brought to light at a number of corporations, large and small, public and private, for-profit and tax-exempt. Some of these problems, including corporate scandals at the national level during the early part of this decade, were the impetus for increased regulation and oversight including the adoption of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and enhanced disclosure requirements regarding the compensation of senior executives required by the Securities and Exchange Commission.[8] Sarbanes-Oxley required the management of public companies, both large and small, to annually assess and report on the effectiveness of internal controls over financial reporting.

While the problems at PEC are not unique, they also are not new. Many of the same issues were raised in 1983 by the Public Utility Commission in response to an application by PEC for a rate increase. At that time, PEC's accounting policies and rates were still regulated by the Public Utility

[8] The U.S. Sarbanes-Oxley Act, 2002.

Commission. In reviewing PEC's rate application, the Director of Accounting at the Public Utility Commission expressed concerns about the apparent conflicts of interest between a PEC employee, Mr. A.W. Moursund, and PEC. The Public Utility Commission also questioned the lack of adequate documentation for expenses paid by PEC on behalf of certain Directors and employees, including travel expenses at more expensive hotels and for Directors' and employees' wives and children.[9] The Pubic Utility Commission's Director of Accounting recommended "sweeping reforms in the cooperative's business practices…and also referenced the expense accounts of the utility's General Manager and Directors as being excessive.[10] However, it appears that the Public Utility Commissions efforts to address these issues were largely to no avail, as many of the same issues were observed during the period under investigation.

In many respects, the Cooperative was managed and essentially controlled by a relatively small number of individuals for many years, with Mr. Fuelberg exercising primary control and authority over the Cooperative, as well as over the Board. The lack of controls and effective Board oversight allowed PEC's former Senior Management to enter into questionable transactions, receive significant compensation, and operate the Cooperative inefficiently, as well as on a basis contrary to the best interests of the Cooperative's members.

[9] Direct Testimony of Billy G. McEuen, Accounting Division, Public Utility Commission of Texas, Docket No. 5109, Re: Application of Pedernales Electric Cooperative, Inc. for a Rate Increase, June 1983, p. 16-18.

[10] The Highlander, *Pedernales Electric Cooperative, Inc. interest conflict alleged*, June 30, 1983.

II. Scope and Objectives of the Investigation

A. Background

1. Pedernales Electric Cooperative, Inc.

Pedernales Electric Cooperative, Inc. ("PEC") is a private, non-profit cooperation organized in 1938 pursuant to the Texas Electric Cooperative Corporation Act for the purpose of providing reliable, low-cost electric service to its members. Headquartered in Johnson City, Texas, PEC currently serves over 226,000 members living in a 24-county, 8,100 square-mile non-contiguous service area.[11] With annual revenues exceeding $450 million and total assets over $1.1 billion, PEC is currently the largest electric cooperative of over 900 member-owned electric cooperatives in the United States.[12]

As a cooperative, PEC is owned by its members, who are also the customers for the electric service provided by PEC. The business and affairs of PEC are managed by a seven member Board of Directors ("Board"), which is composed of one Director from each of the Cooperative's seven Districts. Seven non-voting Advisory Directors are also elected to represent each District and the Board has the option of appointing up to four Advisory Directors at-large. The Board appoints a General Manager to run the day-to-day operations of the Cooperative.

2. Class Action Lawsuit (Worrall Litigation)

On May 16, 2007, Lee Beck Lawrence, individually and on behalf of all others similarly situated (the "Plaintiffs"), filed a lawsuit in Travis County District Court (seeking class action status) against PEC and PEC's Board and management (the "Defendants"). The lawsuit alleged various causes of action against the Defendants regarding their management of PEC over the years, including allegations that they breached their contractual and fiduciary duties, and were negligent and/or grossly negligent in the management of PEC's operations. More specifically, the lawsuit focused on the payment of alleged excessive compensation, benefits, and expenses of the Defendants; PEC's investment in and acquisition of its wholly-owned subsidiary Envision Utility Software Corporation ("Envision"); and PEC's policies regarding the retirement of member patronage capital (i.e., capital credits).[13]

In the Plaintiff's First Amended Petition filed on June 15, 2007, Lee Beck Lawrence was replaced as the named plaintiff by John Worrall, Glenn Van Shellenbeck, Joseph R. Krier, and Linda G. Evans, and the lawsuit was subsequently dismissed and re-filed under a new cause number (hereinafter referred to as the "Worrall litigation" or "class action lawsuit.")[14] While the named Plaintiff changed, the allegations raised against PEC were largely consistent between the two pleadings.

[11] The referenced number of members refers to the number of "meters" serviced by Pedernales Electric Cooperative, Inc. The number of customers is less (approximately 200,000) given that certain customers have more than one meter.

[12] Pedernales Electric Cooperative, Inc. Annual Report 2007.

[13] Plaintiff's Original Petition - Lee Beck Lawrence, individually, and as a representative of all others similarly situated v. Pedernales Electric Cooperative, Inc. et al., Cause No. D-1-GN-07-001434.

[14] Plaintiff's Original Petition, John Worrall, individually, and as a representative of all others similarly situated v. Pedernales Electric Cooperative, Inc. et al., Cause No. D-1-GN-07-0022234.

3. Expressed Concerns by Members, the Media, and Other Interested Parties

Throughout the course of the class action lawsuit in 2007 and into 2008, certain information was released to the media and/or the general public regarding the class action lawsuit and the Plaintiffs' allegations. The released information fueled additional concerns and questions, as well as open public debate, regarding asserted financial impropriety by PEC's former Senior Management and Board. Many of the claims centered around the compensation, benefits and expenses of both management and the Board, and a general alleged misuse of corporate funds, as well as PEC's ongoing payments to support the operations of the Envision subsidiary. Additional questions were also raised regarding the Board election process, potential conflicts of interest, payments to various consultants and others, including former employees, certain "no-bid" contract arrangements, and a general lack of transparency with respect to the business dealings of the Cooperative as perceived by its members.

4. Participants Targeted by the Class Action Lawsuit

Former Senior Management

Aspects of the class action lawsuit and much of the subsequent media and public attention focused on the then-current management of PEC including Mr. Bennie Fuelberg, General Manager of PEC and Treasurer of the wholly-owned Envision subsidiary; Mr. Bud Burnett, an executive employed by PEC in the position of "Coordinator" who was also President of the PEC Board and of the Envision subsidiary; and Mr. Will Dahmann, Assistant General Manager of PEC (these three individuals collectively referred to as "former Senior Management"). At the time the litigation commenced, Mr. Fuelberg had served as the General Manager of PEC for over 30 years and had been employed by PEC for over 35 years. Mr. Burnett was a long-time Director on PEC's Board (for over 40 years). Mr. Burnett was also compensated as a full-time employee (Coordinator) for over 20 years (since 1987). Mr. Dahmann was employed by PEC for approximately 29 years and served as an Assistant General Manager of PEC since 1992.

Board of Directors

PEC's entire Board, consisting of seven voting Directors, seven non-voting or Advisory Directors, and three Advisory Directors at-large, were also original defendants in the class action lawsuit. In addition to Mr. Burnett, the PEC Directors included E.B. Price, O.C. Harmon, R.B. Felps, Val Smith, Vi Cloud, Barry Adair, Kenneth W. Kennedy, Lamont Ramage, Libby A. Linebarger, Ola Armstrong, Blas Tenorio, Rusty Allen, Stuart M. Nunnally, Duwan L. Ruff, Robert A. Reed, Jr. and Barbara Shaffer.

As with former Senior Management, many of the Board members had long-standing histories with PEC and its Board. The average tenure of Directors on PEC's Board was approximately 17 years, with the longest serving Board member being Mr. Burnett, with over 40 years on the Board, and the newest Board member being Mr. Adair, with less than three years on the Board.

5. Senior Management Change

On January 3, 2008, with the resignations of Messrs. Fuelberg, Burnett and Dahmann pending, the Board announced that it had selected Juan Garza to become the new General Manager of PEC. Mr. Garza had been General Manager of Austin Energy, the City of Austin's municipally owned electric utility, and had held prior positions in municipal administration. A condition required by Mr. Garza in connection with his retention was that he be delegated authority from the Board to retain an outside forensic consultant and investigative firm to conduct an independent internal investigation into the past practices of PEC and former Senior Management in connection with the claimed abuses. Mr. Garza's employment started on February 11, 2008.

6. Retention of Independent Counsel and Navigant Consulting

As a first step to restoring credibility in PEC management and the Board, Mr. Garza initiated efforts directed toward a complete internal investigation into the historical accounts, books and records, financial management, and operations of the Cooperative. Mr. Garza, on behalf of PEC, retained Cox Smith Matthews Incorporated ("Cox Smith") to provide independent legal advice and assistance in connection with the investigation. Cox Smith in turn engaged Navigant Consulting as professional advisors to provide forensic investigative and information technology consulting services. Navigant Consulting and Cox Smith were formally retained via separate engagement letters dated April 10, 2008.[15]

7. Settlement Agreement

On March 10, 2008, an agreement was reached between the parties in the class action lawsuit including the execution of a settlement agreement. In summary, the settlement provided for mutual releases of the parties in the litigation; the certification of the class action status of the litigation; the retirement of $23,000,000 in patronage capital by PEC through bill-credits to then-current members over a five-year period; the payment of up to $4,000,000 in attorneys fees and out-of-pocket costs by PEC in connection with the suit; agreed mutual support for the terms of the settlement; and the performance of an "independent internal investigation" of PEC by Navigant Consulting covering a period of ten years prior to December 31, 2007. The settlement was subsequently approved by the presiding judge in the case on May 5, 2008, but was later appealed by several parties.[16]

8. Public Utility Commission Oversight

The Public Utility Commission, at the request of Mr. Garza, and with support from Senator Troy Fraser and Representative Patrick Rose, agreed to provide oversight in the direction of the independent investigation conducted by Navigant Consulting. In addition to ensuring that a

[15] Navigant Consulting submitted an initial proposal to Mr. Garza on February 17, 2008, which became the basis of Navigant Consulting's subsequent retention by Cox Smith, on behalf of Pedernales Electric Cooperative, Inc. and Mr. Garza. The scope of services, as outlined in Navigant Consulting's engagement letter, does not differ from that originally outlined in the initial proposal.

[16] Notice of Appeal, John Worrall, et al., Plaintiffs, v. Pedernales Electric Cooperative, Inc., et al., Defendants, May 29, 2008.

thorough and complete investigation was conducted, the Public Utility Commission was tasked with the objective of providing assurance that Navigant Consulting's efforts, and the resulting report, were not subject to any improper influence of either PEC management or the Board, and that Navigant Consulting's work would include evaluating appropriate benchmarks and standards to apply to PEC's operations prospectively.

Throughout the investigative process, a team of professionals from the Public Utility Commission has been integrally involved in monitoring, evaluating, and providing significant input into the work steps performed by Navigant Consulting. In addition, the representatives from the Public Utility Commission have employed their knowledge and expertise to help identify needed improvements in PEC's operations with a focus on "best practices" in the electric utility industry.

B. Objectives of the Investigation

1. Overview

In conducting the investigation, Navigant Consulting has been guided by (i) the scope of work as defined on behalf of PEC by Juan Garza; (ii) issues raised in the class action lawsuit and by others; and (iii) guidance provided by the Public Utility Commission in providing oversight throughout the investigative process.

The primary objective of our efforts has been to investigate and evaluate matters within the broad scope of the engagement, while maintaining independence throughout the investigative process. As initially agreed to with Mr. Garza, and subsequently expanded pursuant to the settlement agreement, Navigant Consulting's task has been to conduct an independent internal investigation into the financial management and operations of PEC during the period January 1, 1998 through December 31, 2007 (the "period under investigation"), with emphasis on the most recent five years.

Given the breadth of the defined scope of work, Navigant Consulting approached the engagement with the objective of striking an appropriate balance between obtaining adequate information to reach an informed conclusion and avoiding the imposition of excessive burden, an unacceptable time frame, and undue expense upon PEC. However, it was understood by all parties, including Mr. Garza, the Board, and the Public Utility Commission, that if evidence of fraud or other impropriety was uncovered, Navigant Consulting would expand its work plan in an appropriate manner to address that evidence.

2. Settlement Agreement

While the principles of Navigant Consulting's retention were already agreed to with Mr. Garza, our retention was memorialized in the settlement agreement between the parties to the class action lawsuit on March 10, 2008 and subsequently approved by the presiding judge on May 5, 2008.[17] It is important to note that Navigant Consulting was not retained by any party to the class action a

[17] Settlement Agreement, John Worrall, et al., Plaintiffs, v. Pedernales Electric Cooperative, Inc., et al., Defendants, May 29, 2008.

lawsuit, other than PEC, and our work was not directed at addressing any specific claim asserted or question raised on behalf of the litigants, other than as may otherwise be encompassed within the scope of our engagement on PEC's behalf.

Consistent with the independent, objective and impartial nature of Navigant Consulting's investigation, we continue to be independent from the various parties and their counsel involved in the class action lawsuit and litigation process, including the PEC Board. With the exception of limited interaction at various points in the investigation to request information in the possession of counsel representing PEC in the litigation, as well as interviews of certain members of PEC's Board, we have disclosed only very limited information to any party involved in the class action lawsuit regarding any preliminary findings or observations. Likewise, with very limited exceptions, no substantive discussions regarding the investigation's observations and findings have been held with any of these parties until the investigation was essentially complete. Navigant Consulting periodically discussed, on a confidential basis, the scope of work and subject matter of the investigation with PEC's external auditors, KPMG L.L.P. ("KPMG") in order to facilitate KPMG's completion of PEC's audited financial statements for 2007.

3. Scope of Services Provided

As noted above, the scope of professional services provided by Navigant Consulting focused on the period from January 1, 1998 through December 31, 2007 and included an independent evaluation of various PEC transactions, business processes and expense items that have received significant attention as a result of the class action lawsuit and related public inquiries over the past eighteen months, as well as new areas identified for review during the course of our investigation. Navigant Consulting's investigation encompassed a detailed analysis and investigation of a wide range of compensation and expense items, business arrangements, interrelationships, and transactions involving PEC management, Directors and various other outside parties, as well as the investigation of allegations or appearance of accounting irregularities, financial misrepresentation, fraud, misuse of corporate funds, and breach of fiduciary duty.

More specifically, Navigant Consulting's efforts focused on the following areas:

- Executive management compensation and benefits
- Board of Director compensation and benefits
- Executive management expenses/expense reimbursement (travel and other)
- Board of Director expenses/expense reimbursement (travel and other)
- Identification and evaluation of transactions with PEC related parties and affiliated entities
- Identification and evaluation of executive management and Board affiliated/related parties
- Use and compensation of outside consultants/contractors/third-party service providers
- Extended and/or non-standard pay/benefits and/or severance packages and payments to retired or former employees and Directors
- Land/property/equipment purchases, as well as non-operating asset purchases
- Construction and vendor/supplier contracts – and PEC's contract procurement method

A part of Navigant Consulting's investigation also included evaluating business practices associated with certain functional areas, such as PEC's retirement or payment of patronage capital (i.e., capital credits) and PEC's ownership and investment in its Envision subsidiary.

Navigant Consulting was also requested to provide certain business process improvement consulting services, including evaluating processes and behaviors observed in relation to those of best-performing electric utilities, and to provide recommendations in relation to the identified potential root causes of issues that were a significant focus of the investigation. The described business process improvement consulting services were the subject of a separate engagement letter between Navigant Consulting and Mr. Garza, on behalf of PEC, also dated April 10, 2008.

The outlined scope of services in the business process area include the following:

- Gathering and analyzing information related to general and specific functional process areas identified by PEC management, such as power planning, forecasting and procurement, information technology, operations, customer service, and strategic planning and budgeting.
- Evaluating the practices observed in relation to those of best performing electric utilities and conducting discussions with relevant PEC personnel regarding the findings.
- Developing potential alternative solutions and recommendations appropriate to each area of review, which may include business process creation, definition and/or role clarification.
- Developing a workable implementation plan that will enable PEC to put the recommended business process solutions into practice in the most cost-effective and sustainable manner.

The services provided by Navigant Consulting in relation to PEC business processes may continue.

C. The Investigative Process

1. Navigant Consulting and Cox Smith Matthews

Navigant Consulting and Cox Smith were retained to investigate the various allegations of corporate abuses and potential wrongdoing. Navigant Consulting's role was to apply financial, accounting and electric utility industry expertise and independence to the design and execution of a forensic investigation of the allegations. Cox Smith, in serving as legal advisor to PEC and the investigative team in connection with the investigation, provided the services of a multi-discipline, independent legal services team with substantial experience in matters pertinent to the electric utility and electric cooperative industry.

Navigant Consulting (NYSE: NCI) is an international firm of advisors and consultants with more than 1,900 professionals located across 42 offices in North America, Europe and Asia, including three offices in Texas (Austin, Dallas and Houston). Navigant Consulting specializes in assisting major corporations, their Boards of Directors, and inside and outside counsel in conducting high-profile forensic accounting investigations, often involving allegations of corporate fraud, management impropriety and/or misconduct, and other white collar crime matters. Navigant Consulting is also a leading management consulting firm in the energy sector and through our Business Operations Advisory practice we work with many of the leading electric utility and power enterprises in the country.

Navigant Consulting's efforts in the investigation were lead by Todd K. Lester. Mr. Lester was assisted by a cross-disciplinary team of 10 – 12 consultants, which included significant investigative experience and extensive electric utility and public power experience. Navigant Consulting professionals who assisted during the investigation included consultants with former Big 4 accounting firm experience, Certified Fraud Examiners, an Accredited Senior Appraiser (business valuation), information technology and computer software solutions experts, specialists in the identification and retrieval of electronic information from computer systems and networks, and two consultants who each have over 35 years of experience working in the electric utility industry including significant experience in utility operations, organization, governance issues, asset evaluations, information technology, and resource planning.

Licensure**:** Navigant Consulting (PI) LLC is licensed by the Texas Private Security Board under license number A14814. Navigant Consulting is not a licensed accounting firm.

2. Forensic Investigations

Navigant Consulting is typically retained to conduct independent investigations at the direction of special committees and audit committees of Boards of Directors, or by members of the executive management team and their counsel in response to both internal concerns, as well as external inquiries by the Securities and Exchange Commission, the U.S. Department of Justice, and other regulatory agencies.

For the PEC investigation, as with many investigations Navigant Consulting undertakes, relevant information for our review and analysis was gathered from a variety of sources, which assisted in identifying areas for investigation, as well as providing information relevant to those areas. While each investigation has its unique characteristics, the investigation process applied to PEC contained elements similar to those utilized by Navigant Consulting in other investigations of financial and management activities. As applied to PEC, these steps included:

- Meeting with relevant parties to gain an initial understanding of issues to be addressed and proposed coordination of our efforts;
- Identifying and reviewing relevant information to gain understanding of PEC's business and organization and the electric utility and electric cooperative industry in general;
- Identifying relevant electronic records and extracting and reviewing necessary information;
- Reviewing and evaluating PEC historical policies and procedures, authorizations, delegation of authority, and other management practices in relation to operation of the Cooperative;

- Preparing summaries and analyzing payments to various parties including compensation, benefits, perquisites, and expenses of former Senior Management and the Board;

- Evaluating PEC's relationships with related parties and/or affiliated entities, as well as various third-party providers of professional services, including analyzing payments to various consultants, law firms and financial services firms;

- Evaluating PEC's contracts, agreements, and relationships with vendors/suppliers;

- Reviewing asset purchases, with emphasis on land and non-operating assets, relative to the facts and circumstances surrounding each purchase;

- Reviewing applicable Board and Committee meetings minutes and resolutions relative to the areas being investigated;

- Summarizing and analyzing investments, payments, and funds transfers between PEC and the Envision and Texas Skies subsidiaries;

- Interviewing individuals with information relevant to the areas being investigated and identifying additional areas for review;

- Developing an understanding of the processes followed regarding Board governance, management decision-making, delegation of authority, and relevant internal controls;

- Evaluating information obtained during the course of the investigation for evidence or indicia of asset misappropriation, fraud, improper payments, and management and/or Board impropriety or misconduct; and

- Integrating information learned from identified documentation, interviews and analyses, and summarizing our observations, findings, and recommendations.

While there is no definitive legal guidance precisely prescribing the manner in which an investigation of this nature should be performed in all cases, such investigations generally must be conducted with reasonable care, independence, and good faith.[18] In determining whether an investigation meets these standards, consideration is given, among other things, to: (i) the investigation's involvement of capable counsel and other professionals to assist in the investigation; (ii) the independence and level of expertise of the investigative team members, (iii) the investigation's review of documents and electronic information; and (iv) the investigation's conduct of witness interviews.[19]

In order to focus investigation resources on areas most subject to potential abuse and/or mismanagement, our team began by identifying areas in which PEC's former Senior Management

[18] See e.g., Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[19] See e.g., Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Carlton Investments, 1997 WL 305829 at *10-11; Kaplan, 499 A.2d at 1188-92.

exercised the greatest degree of control. Given the breadth of the scope of the investigation, in areas in which neither witness interviews nor analysis of financial and accounting records yielded evidence of inappropriate transactions or behavior, we limited our efforts accordingly.

3. Independence, Integrity and Objectivity

At all times during the investigation, Navigant Consulting has remained independent of the Cooperative, its Board and management. Prior to accepting the engagement, Navigant Consulting performed a check based on the names of the parties involved in this matter, and we identified no circumstances or prior material relationships with current or former management or the Board that constituted a conflict of interest or that could have impaired our ability to provide objective assistance.

Throughout the course of the investigation, Mr. Garza was engaged with Navigant Consulting and Cox Smith, and together with representatives from the Public Utility Commission, jointly supervised and directed the scope of the investigation. However, notwithstanding the input provided by Mr. Garza and the Public Utility Commission, these participants placed no restrictions on the scope of the investigation (nor did the PEC Board or any other entity) and Navigant Consulting has exercised its professional judgment regarding the scope, timing and nature of our work in the investigation.

Neither Navigant Consulting, Inc. nor Navigant Consulting (PI) LLC is a public accounting firm. Navigant Consulting did not audit any financial statements or perform any attest procedures in the course of this engagement. Our services are not designed, nor should they be relied upon, to disclose financial statement errors or financial statement disclosure deficiencies. KPMG has been and is currently acting as PEC's auditor. Any audit or attest function that PEC may require now or in the future will be handled by KPMG or another licensed public accounting firm as designated by PEC.

Navigant Consulting's role in this project has been that of a special independent investigator, which is different from that of an independent auditor. Auditors plan and perform audits to obtain reasonable assurance that financial statements are free from material misstatement, and that the financial statements are fairly presented in conformance with Generally Accepted Accounting Principles ("GAAP").[20] A special investigation, on the other hand, is not defined by any concept of materiality or necessarily by GAAP, and is typically much broader and more in-depth in scope than an audit. An investigation involves a focused search for, and evaluation of facts relevant to, potential fraud, corporate misconduct and/or financial impropriety, as well as other questions of concern.[21]

4. Electronic Information Identification, Preservation and Recovery

Navigant Consulting's efforts included the identification, preservation, and recovery of potentially relevant information in the form of archived electronic records of PEC including electronic data, files and media for the period beginning January 1, 1998 through December 31, 2007. Sources of this

[20] AICPA Professional Standards (AU Section 110).

[21] Joseph T. Wells, Sherlock Holmes, CPA, Part 1, Journal of Accountancy at 86, August 2003.

information included current PEC e-mail, file servers and backup tapes, as well as forensic hard drive images and portable media from specified custodians deemed responsive to the investigation.

A preservation notice was sent on May 25, 2007 to certain company personnel (i.e., the Board, all managers and outside consultants) by the former General Manager, Mr. Bennie Fuelberg, directing the preservation of certain hard-copy and electronic information potentially relevant to the class action lawsuit.[22] A subsequent preservation notice was sent on May 27, 2008 at the request of Cox Smith instructing the continued preservation of certain records relevant to the class action lawsuit as well as records deemed responsive to the scope of the investigation.[23]

Through our efforts we identified various data stores that contained information potentially relevant to the investigation, including the following:

- E-mail on the Cooperative's Exchange Server
- Laptop/Desktop Drives of Certain Custodians
- Network File Shares/User Files
- Historical E-mail Stores (PST files)
- Images of Former Employee Hard Drives
- Backup Tapes
- EDMS (Electronic Data Management System) Servers
- Loose Electronic Media/Portable Storage Devices
- Files on Litigation Hold from Unrelated Matters

A separate memorandum was prepared documenting the electronic information identification, preservation and recovery efforts undertaken during the investigation, as well as the analysis of forensically imaged computer hard drives. A copy of that memorandum, with supporting exhibits, is provided in Appendix A.

5. Document and Electronic Information Review and Analysis

During the course of the investigation, Navigant Consulting and Cox Smith reviewed over 150,000 pages of hard copy documents and files, including information provided through the class action lawsuit and documents produced at our request from various departments within PEC.

In addition, as part of our efforts to obtain documentary evidence, members of the investigative team had full access to electronic records available at PEC. Navigant Consulting worked with Cox Smith to search for e-mails and other electronic records and documents that were relevant to the investigation. To that end, we created searchable databases of e-mails and user-files and performed an electronic search of key words deemed potentially relevant to our investigation, which yielded

22 Memorandum from Bennie Fuelberg to Board of Directors, All Managers, Outside Consultants, Re: Litigation Hold Notice, May 25, 2007.

23 Memorandum from Kimberly Paffe to Board of Directors, All Managers, Outside Consultants, Re: Litigation Hold Notice, May 27, 2008.

25,553 e-mails and other documents, each of which was reviewed by professionals from Navigant Consulting and/or Cox Smith.

We identified and reviewed approximately 23 Gigabytes (GB) of potentially relevant e-mails and user-files from computers, computer networks and network backup tapes (which is estimated at approximately 1.3 million pages of information). In addition, we identified and reviewed approximately 125,000 general ledger transactions from a variety of areas including various administrative and general expense accounts.

6. Interviews of Key Personnel

Throughout the course of the investigation, we attempted to interview all those individuals who, to our knowledge, were likely to have significant information relevant to our inquiry. To that end, Navigant Consulting, with the participation of Cox Smith in some instances, interviewed 80 witnesses. Several of these witnesses became repeated sources for our investigation, speaking to the investigation team members on a routine basis during the course of our efforts.

The witnesses interviewed for our investigation included current and former employees of PEC, as well as current and former Board members and outside parties.

Six Board members were interviewed by Navigant Consulting in connection with its information-gathering process – Messrs E. B. Price, O. C. Harmon, Val Smith, Barry Adair, and Ms. Vi Cloud, all of whom were Voting Directors at PEC during the period under investigation, and Ms. Libby Linebarger, who was an Advisory Director-at-large during the period under investigation. Ms. Cloud, Mr. Harmon, and Mr. Smith are presently voting members on the Board.[24] Mr. Price was Vice President of the Board and acted as interim President following Mr. Burnett's resignation. Navigant Consulting had planned to interview the other Directors, including the remaining voting, Advisory, and Advisory Directors-at-large who were on PEC's Board during the period under investigation. After the completion of the six interviews referred to above, however, counsel for the individual defendants in the class action lawsuit insisted that any further interviews of their clients should be requested through such counsel. Such counsel thereafter took the position that their clients would not participate in interviews relating to the subject matter, claims, or allegations in the class action lawsuit and/or the appeal of the final judgment in the class action lawsuit unless either publication of the Navigant Consulting report was withheld until after the settlement became final or PEC agreed that the releases given in the settlement would remain binding regardless of the outcome of the appeal. These conditions were unacceptable to PEC. Further discussions aimed at resolving these issues were unsuccessful and the remaining interviews did not go forward.

Navigant Consulting believes that the interviews conducted with the six Directors and former Directors who were interviewed provide a valid and substantive information base, along with other documentary and interview data to which Navigant Consulting had access, for the observations included in the Report. Four of the interviewed Directors were voting Directors with relatively long-

[24] Mr. Adair was interviewed via telephone. He was a Voting Director during only a portion of the period under investigation (i.e., since May 2005).

term tenures on the Board; all of those interviewed provided, in our view, thorough, candid, and forthcoming comments during their interviews. All of them had had ample opportunity over the years of their tenure to observe management and organizational elements of the Cooperative's operation, and their observations were relatively consistent as a group.

7. Information Reviewed and Relied Upon

We have been informed by Cox Smith that certain documents have not been produced to Navigant Consulting due to attorney-client privilege. As such, the contents of those materials were not reviewed or included as a part of this Report.

The attorney-client privileged information was not available for our review to the extent such material related to (i) PEC's negotiations relating to its wholesale power contract with the Lower Colorado River Authority; (ii) Human Resources related matters affecting individual employees of PEC; and (iii) the pending class action lawsuit (i.e., *Worrall* litigation). Likewise, as noted in the section of this Report relating to Third Party Service Providers, additional investigation may be required, and additional records may need to be sought, in connection with issues raised by certain invoices for legal fees, as this remains an open item to this Report.

D. Limitations

Certain practical limitations existed as to the information available during the investigation.

1. Inability to Compel Third Parties to Provide Information

Although management and the Board directed PEC employees to cooperate with us, we had no power to compel non-PEC third parties to submit to interviews, produce documents, or otherwise provide information.

2. Reliability of Information Obtained through Interviews

Differences may exist between information obtained through voluntary informal interviews of the type Navigant Consulting conducted in contrast to document requests and information obtained through testimony and cross-examination under oath or by compulsory legal process. Moreover, particularly given the circumstances surrounding the public attention and pressure regarding PEC's former Senior Management and current and former Board members, as well as the investigation, some of the people we interviewed may have been motivated to describe events in a manner colored by self-interest or through the benefit of hindsight. We made every effort to maintain objectivity, notwithstanding these constraints.

Within these inherent limitations, we believe that our investigation was extensive, careful, independent and impartial, and that the facts developed afford a reasonable foundation upon which to base the observations, findings and recommendations set out in this Report.

3. Unavailability of Information Due to Document Retention Policies

Given the ten-year scope of the investigation (1998 – 2007), requested information was not always available or reasonably accessible, especially with respect to the earlier years under review. Because of employee departures, as well as the former General Manager's propensity to rotate employees among various positions, we did not always find direct institutional knowledge with regard to certain transactions and issues being investigated. In addition, certain current and former employees interviewed were able to recall relevant facts and circumstances with only a limited degree of specificity. Available hard-copy or imaged documentation from PEC's electronic data management system (EDMS) may have been limited by the cooperative's document retention policy and the respective discipline with which each department adhered to the policy.

In such instances, our investigations often place greater reliance on available electronic information including e-mail and user-files that may have been retained or backed-up to tape storage devices. However, personal computers were not routinely provided to the Cooperative's managers until a few years ago and e-mail was discouraged as a form of business communication. As a result, while certain electronic information was reviewed and considered in our investigation, the extent of that information was somewhat limited by PEC's historical management policies.

4. Limited Review of KPMG Documents

We have reviewed the documents that KPMG produced in response to the class action lawsuit, but we have not reviewed any other KPMG workpapers.

5. Destruction of Hard-copy and Electronic Files and Information

During the course of our investigation, certain issues came to our attention with regard to the preservation of both hard-copy documents and electronic information. Despite the existence of a notice directing the preservation of information in connection with the class action lawsuit (and later in connection with this investigation), certain hard-copy files and electronic information (including e-mails) appear to have been destroyed. Our inquiries and investigation into the missing information have led us to conclude that, while certain information was inadvertently destroyed, other electronic and hard-copy files and information appear to have been intentionally destroyed, including electronic information that was resident on several laptop computers in the possession of the former General Manager, as well as certain hard-copy files that were maintained under his direction and control.

At present, it has not been determined whether or to what extent the missing materials contained important information. However, based on experience in other investigations, it is likely that certain of the unavailable hard-copy and electronic information would have been relevant to our investigation and the ultimate conclusions expressed in this Report.

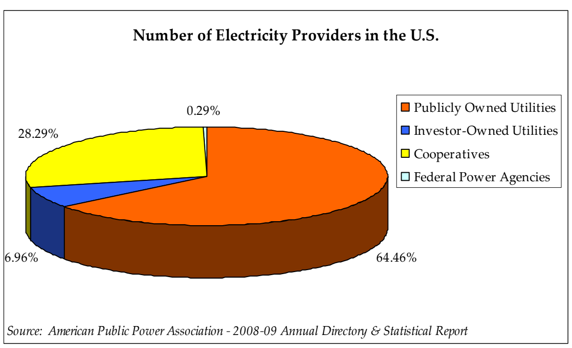
III. Overview of Electric Utility Industry, Cooperatives and PEC

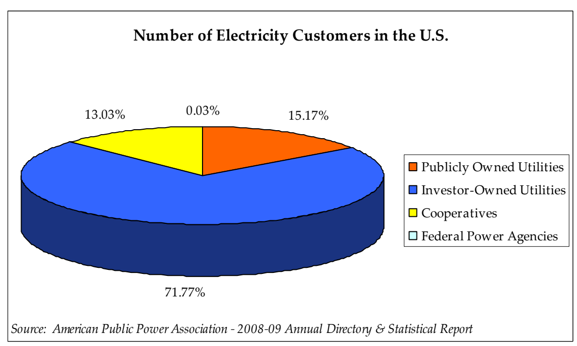
A. Electric Utility Industry

The U.S. electric power industry is a collection of investor-owned, cooperative, municipal, state and federal utilities that serve over 140 million residential, commercial and industrial customers across the U.S.[25] The vast majority of electric customers served are residential (87%), yet residential customers account for only a little over a third (37%) of the total electricity consumed in the U.S.[26]

There are more than 3,100 traditional electric utilities in the U.S.[27] While the U.S. power industry is becoming increasingly diverse, there are basically three kinds of traditional electric utilities selling power at the retail level: government-owned utilities, electric cooperatives and shareholder or investor-owned utilities ("IOUs").[28]

The majority of electric utilities (approximately 65%) are publicly-owned and operated (i.e., public power), primarily by local government agencies. However, most are relatively small as they only account for approximately 15% of the total electric utility sales in the U.S. Electric cooperatives number close to 900, or almost 30% of the all electric utilities, but also account for less than 15% of electric utility sales and revenues. IOUs are privately-owned businesses that represent less than 10% of the number of electric utilities, but account for almost 70% of the electric utility sales and revenues. The representative number of electric utilities and customers served by each is summarized below:





B. Electric Cooperatives

The rural electric cooperative sector is a critical part of the U.S. electric industry. It has traditionally provided electricity service to those parts of the country where other utilities historically have had no

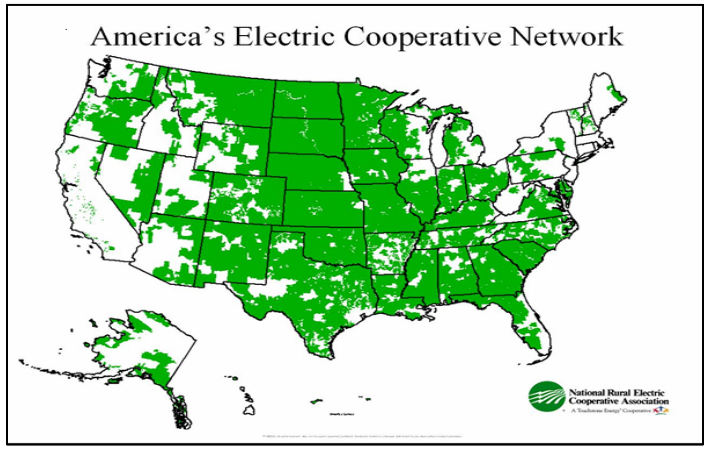
25 EIA Electric Power Annual 2006 data.

26 Key Facts - about the Electric Power Industry, Edison Electric Institute.

27 Electric Power Industry Overview, Energy Information Administration (U.S. Government).

28 There are also new electricity suppliers, in response to competition, that are vying to compete in wholesale and retail electricity markets. Key Facts - about the Electric Power Industry, Edison Electric Institute.

interest in doing business.[29] Most electric cooperatives were formed in the 1930s and 1940s to provide electricity to rural areas that IOUs would not serve.[30,31] Cooperatives provide electric service to over 17 million customers, or approximately 12% of the U.S. population, while maintaining 42% of the nation's electric distribution lines.[32] There are over 860 electric distribution cooperatives nationwide with annual revenues exceeding $30 billion.[33]



Electric cooperatives are private entities having the status of non-profit corporations that are owned by the customers (i.e., members) they serve. Thus, they are not governmental entities (although they are often referred to as "public power" by virtue of being member-owned), nor are they for-profit companies. Electric cooperatives are created for the benefit of their members/owners to provide electric service on a cost-effective basis. Cooperatively owned electric utilities are generally unregulated and exempt from paying federal income taxes.

There are 74 electric cooperatives in Texas – 65 distribution cooperatives and 9 generation and transmission cooperatives – serving more than 3 million members/owners. Texas electric cooperatives own more than 286,000 miles of electric lines serving more than 1.6 million meters in 232 of the state's 254 counties.[34]

In general, cooperatives are a type of corporation; a state-chartered business organized and operating under state law. And, while cooperatives resemble other businesses – they have physical facilities, perform similar functions, and are expected to follow sound business practices – cooperatives are owned and controlled by their members (i.e., the people who use their services). Cooperatives generally are managed by a Board of Directors elected from the members, derive equity from members, are operated for the benefit of members and allocate earnings to members based on use.[35]

Cooperatives also provide services to their members on a non-profit basis (and are exempt from federal and state income taxes) thereby eliminating the need to generate profits or a return on equity.

[29] Total U.S. Electric Cooperative Power Distribution Equipment and Energy IT & Services Markets, Frost & Sullivan, April 2006.

[30] Cooperative Businesses in the United States…a 2005 Snapshot, Prepared by the National Cooperative Month Planning Committee, October 2005.

[31] The Rural Electrification Administration was created in 1935 to fund projects by rural cooperatives.

[32] Electric Industry Overview, Cooperative Electric Utilities, National Rural Electric Cooperatives Association.

[33] 2006 EIA data (NRECA Feb. 2008).

[34] Texas Electric Cooperatives, History of Electric Cooperatives.

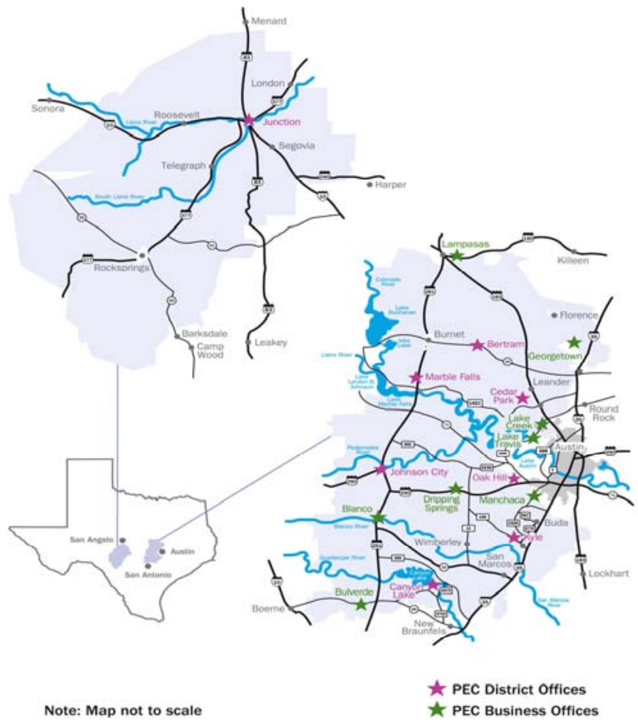
[35] Cooperatives: What They Are and the Role of Members, Directors, Managers, and Employees, United States Department of Agriculture, Rural Business Cooperative Service, RBS Cooperative Information Report 11.

A cooperative's electric rates are designed to recover costs of service, and to collect an amount of revenue in excess of expenses (commonly referred to as "net margins") sufficient to meet debt-service coverage requirements, establish reasonable reserves and accumulate member equity.

Almost all cooperatives follow the same set of guiding principles related to voluntary and open membership, democratic member control, member economic participation, autonomy and independence, focus on education, training and information, cooperation among cooperatives, and concern for community.[36]

C. Pedernales Electric Cooperative

1. Overview of PEC



PEC is a private, non-profit corporation organized in 1938 with the purpose of providing reliable, low-cost electric service to its members. PEC is organized as a cooperative under the Texas Electric Cooperative Act and began operations in 1939. PEC purchases substantially all of its electric power for distribution to its customers from the Lower Colorado River Authority ("LCRA"). PEC has recently executed an amendment and extension to its long-term wholesale power supply contract with LCRA with a term that extends to 2041.

Headquartered in Johnson City, Texas, PEC is an electric distribution cooperative that currently serves over 226,000 members living in a 24-county, 8,100 square-mile non-contiguous service area in central Texas. PEC's service area includes part or all of over 40 municipalities and includes more than 15,000 miles of energized line and 300 miles of transmission line.[37] With annual revenues over $450 million and total assets exceeding $1.1 billion, PEC is currently the largest electric cooperative out of over 900 member-owned electric cooperatives in the United States.[38]

In addition to the headquarters office, PEC is organized across 7 districts with 16 offices serving the following communities and surrounding areas: *Bertram, Blanco, Bulverde, Canyon Lake, Cedar Park, Dripping Springs, Georgetown, Johnson City, Junction, Kyle, Lake Creek, Lake Travis, Lampasas, Manchaca, Marble Falls and Oak Hill.*

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[36] Cooperative Principles, National Rural Electric Cooperatives Association.

[37] Since 1991, Pedernales Electric Cooperative, Inc. has leased substantially all of its transmission lines and facilities to LCRA.

[38] Pedernales Electric Cooperative, Inc. Annual Report 2007.

PEC currently has one wholly-owned subsidiary, Envision Utility Software Corporation ("Envision"). Envision is a for-profit subsidiary organized and headquartered in Albuquerque, New Mexico, with an office in San Marcos, Texas. Envision owns proprietary billing and customer information system software that is utilized by PEC in its ongoing operations. Envision continues to upgrade and enhance the system software utilized by PEC and provides ongoing support services.

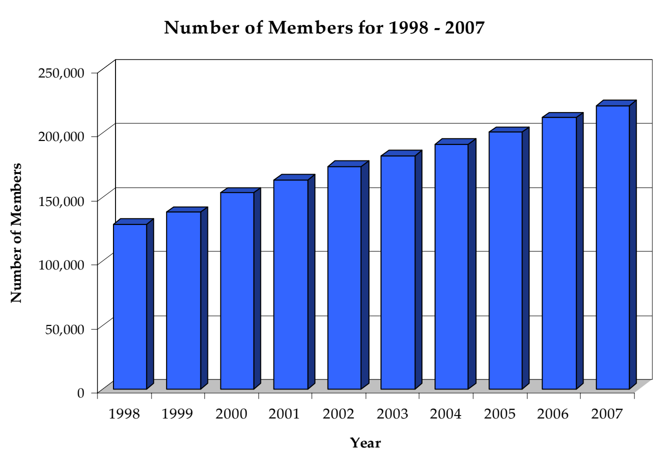
The business and affairs of PEC are managed by a seven member Board of Directors, which is composed of one Director from each of the Cooperative's seven districts. Directors are elected to three-year terms and may be re-elected to successive terms. Seven non-voting Advisory Directors are also elected to represent each District and the Board has the option of appointing up to three Advisory Directors at-large. The Board appoints a General Manager, who performs the duties of the chief executive officer of the Cooperative and runs its day-to-day operations.

As a non-profit, cooperatively organized entity, PEC is currently exempt from federal income taxation pursuant to Section 501(c) (12) of the Internal Revenue Code. Under federal tax laws, to retain this exemption, at least 85% of the Cooperative's income must come from the Cooperative's members.

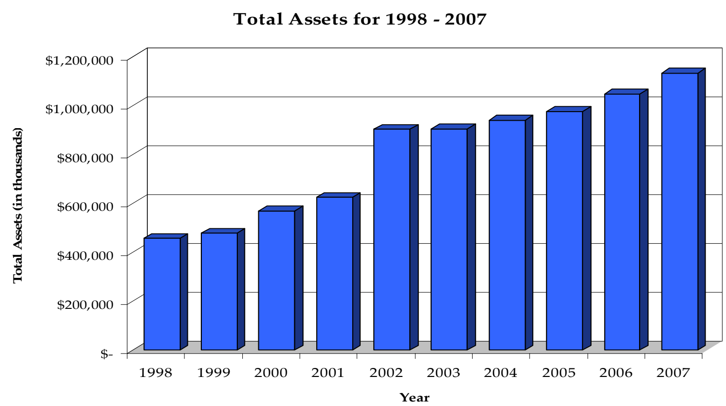
2. Operational and Financial Highlights

During the past ten years PEC has undergone significant changes fostered by unprecedented growth and development in its service territory. PEC experienced rapid growth as rural areas surrounding Austin, San Marcos and San Antonio, Texas rapidly expanded with continuing development, all of which led to the substantial increase in the size of the Cooperative's operations and the number of members it serves.

PEC's membership has grown from over 128,000 members in 1998 to over 226,000 members today, a 77% increase. The growth in the number of PEC customers/members is shown in the following chart:



Both revenues and the financial value of assets have more than doubled for PEC in the past ten years, with total revenues increasing from approximately $180 million to over $450 million and total assets increasing from approximately $455 million to over $1.1 billion. A summary of the increase in PEC's total assets is depicted in the following chart:

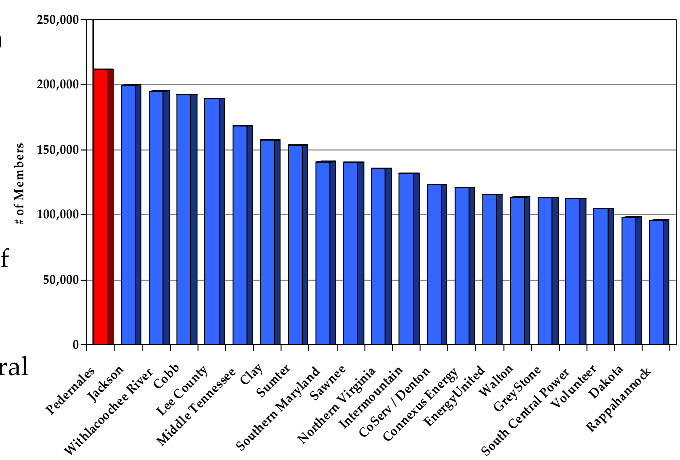


Selected PEC financial data is also presented below for the years 1998 - 2007.

Summary of Select Financial Data from Financial Statements for 1998 - 2007 (In Thousands)	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Income Statement										
Operating revenues	$ 182,421	$ 194,337	$ 240,983	$ 273,689	$ 278,417	$ 305,402	$ 366,238	$ 410,877	$ 495,996	$ 457,012
Purchased power	(110,719)	(115,175)	(147,985)	(164,108)	(146,615)	(166,538)	(196,320)	(239,295)	(274,259)	(263,545)
Net margin (loss)	8,451	3,422	1,870	4,923	13,284	1,847	20,655	19,923	61,967	19,667
Balance Sheet										
Utility plant-net	$ 391,969	$ 431,661	$ 499,172	$ 563,318	$ 623,570	$ 672,098	$ 735,521	$ 797,223	$ 881,081	$ 998,898
Total assets	455,378	477,092	566,840	622,859	900,841	901,979	938,681	973,237	1,044,312	1,129,741
Total debt	286,610	295,310	357,339	395,052	638,805	628,089	615,219	601,630	587,271	626,081
Membership equity	138,191	149,670	164,801	183,743	216,888	230,943	266,241	292,150	370,694	347,343
Total debt/membership	**$ 424,801**	**$ 444,980**	**$ 522,140**	**$ 578,795**	**$ 855,693**	**$ 859,032**	**$ 881,460**	**$ 893,780**	**$ 957,965**	**$ 973,424**
Debt service coverage ratio	1.81	1.55	1.54	1.90	2.27	1.32	1.66	1.67	2.46	1.66

A summary of PEC financial statements for the period from 1998 – 2007 are provided in Exhibit 1.

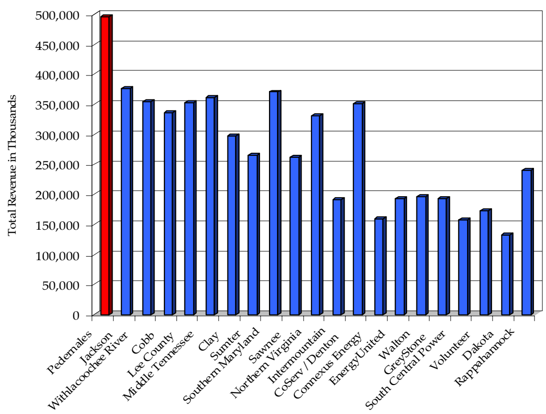
With its 226,000 plus members, PEC is the largest electric cooperative out of over 900 member-owned electric distribution cooperatives in the United States, and has over twice as many members as over 98% of the other electric cooperatives. The average cooperative serves less than 19,000 members and generates revenues of less than $34 million.[39] In fact, only fourteen cooperatives have more than 100,000 members. The vast majority of rural cooperatives have less than 50,000 members.[40]

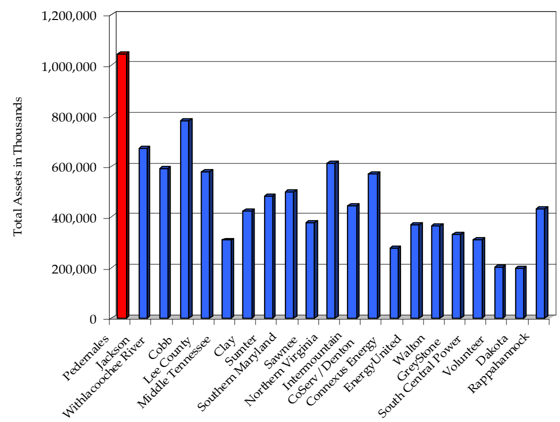


[39] The average publicly owned utility is even smaller; serving a little over 10,000 consumers and generating less than $23 million in annual revenues. The average investor-owned utility (IOU) serves almost 400,000 consumers and generates close to $850 million in revenues

With revenues over $450 million and assets exceeding $1.1 billion, PEC is approximately 30% larger than the next largest cooperative in a financial comparison.[41] In comparison to cooperatives in Texas, PEC's $1.1 billion in assets is almost twice as large as the next largest cooperative.[42]

Comparison of PEC to Largest Co-ops in the U.S. – *Revenues & Assets*

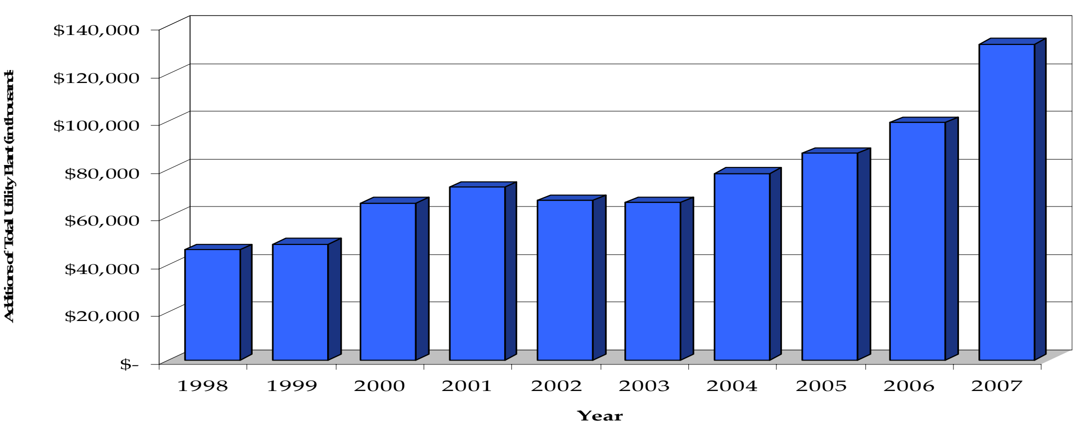




Sources: Energy Information Administration, Energy Velocity, and Annual Reports and other information published by the individual cooperatives.

While revenues have generally grown for electric distribution cooperatives over the past ten years, PEC's rate of growth has far outpaced the growth of the general industry. To keep up with the significant growth in its service area, PEC has made sizeable investments in utility plant over the years and foresees significant continued investments in the future.

Additions of Total Utility Plant for 1998 - 2007



[40] Total U.S. Electric Cooperative Power Distribution Equipment and Energy IT & Services Markets, Frost & Sullivan, April 2006.

[41] Pedernales Electric Cooperative, Inc. Annual Report 2007.

[42] At the beginning of 2007, Pedernales Electric Cooperative, Inc. was one of the top 100 largest cooperatives nationwide across all industries (e.g., agriculture, grocery, energy, healthcare, etc.), America's Top Co-op Companies, Co-op 100, National Cooperative Bank (NCB), 2007.

The table below provides a snapshot of PEC's relative profile as of 2007, with a reference to the growth (i.e., % change) since 1998.

PEC Profile – Characteristics	1998	2007	% Change
Total Utility Plant – Assets	$461,903,819	$1,219,635,205	164%
Total Miles of Energized Line	13,251	16,407	24%
Number of Full Time Employees	510	798	56%
Total kWh Sold	2,572,512,990	4,393,172,000	71%

PEC has primarily funded its growth through the issuance of various mortgage notes and bonds. As of December 31, 2007, PEC had approximately $556 million in outstanding long-term debt in relation to various bonds issued in 1993, 1995 and 2002, as well as a line-of-credit from the Cooperative Finance Corporation ("CFC") with an outstanding balance of $54 million. This line-of-credit is used as interim financing until such time PEC has a need and an opportunity to issue additional long-term debt in the form of mortgage bonds.

PEC has participated in the J.D. Power and Associates Electric Utility Residential Customer Satisfaction survey over the past several years. In each of the past three years (2005 – 2007) PEC's performance has consistently ranked in the top five in overall *Customer Satisfaction* (out of over 70 utilities in the medium-size utilities industry group), as well as in the top ten in *Power Quality and Reliability* and C*ommunication*s. In each of the three years, PEC has ranked first in *Customer Service*.[43]

In addition to funding growth and investment through debt, PEC has also utilized equity contributed by its members (i.e., net margins) from past years. PEC's total "patronage capital" as of December 31, 2007 was approximately $215 million. Approximately 57% of that patronage capital has been contributed in the past ten years, with almost half of it coming in 2006 when PEC had net margins exceeding $60 million.

In addition to patronage capital, there are several other components that make up the total value of member equity, including membership certificates, and the value of certain contributed facilities consisting primarily of facilities constructed by real estate developers and donated to the Cooperative. A summary of PEC's capitalization structure is provided below:

Summary of Membership Equity and Long-Term Debt for 1998 - 2007 (In Thousands)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Membership Equity:										
Membership Certificates	$ 4,468	$ 4,861	$ 6,160	$ 7,414	$ 8,584	$ 9,649	$ 10,588	$ 10,561	$ 10,822	$ 11,438
Contributed Facilities	40,251	47,915	54,881	67,645	86,336	97,479	111,183	117,196	133,513	151,273
Accum. Other Comprehensive Income	-	-	-	-	-	-	-	-	-	(31,050)
Patronage Capital	93,472	96,894	103,761	108,684	121,968	123,815	144,469	164,392	226,360	215,681
Total Membership Equity	$ 138,191	$ 149,670	$ 164,801	$ 183,743	$ 216,888	$ 230,943	$ 266,241	$ 292,150	$ 370,694	$ 347,343
Long-term Debt, Net of Current Maturities	$ 281,365	$ 275,297	$ 328,884	$ 357,726	$ 628,089	$ 615,219	$ 601,630	$ 587,271	$ 572,081	$ 556,024

43 J.D. Power and Associates, Electric Utility Residential Customer Satisfaction Studies: 2005, 2006 and 2007, *Overall Customer Satisfaction Index* and *Power Quality and Reliability*.

While investment requirements and costs have been high for PEC over the past decade, PEC has continued to provide generally competitive electricity rates for its members, as well as highly-ranked service and reliability. PEC's level of revenues and its net margins and resulting patronage capital at year-end are determined by its established rates and the use of electricity in its service area. Since September 1999, PEC's has had the authority to establish its own, as well as the ability to change rates as needed. The principal component of PEC's rates is the cost of electricity purchased by PEC for distribution and resale to its customers.

PEC purchases the vast majority of its electricity from LCRA. Over the past ten years, PEC's purchased power costs have averaged approximately 60% of its total costs. Purchases from LCRA have been made pursuant to a long-term Wholesale Power Agreement, as amended in May 1987, and in November 2008.[44]

At one time PEC's rates were subject to regulation by the Public Utility Commission. However, in 1999 the Texas legislature passed Senate Bill No. 7 ("SB 7"), which fundamentally redefined and restructured the Texas electric industry. SB 7 provided for retail electric open competition to begin for IOUs in January 2002. In addition, municipal and electric cooperative utilities were allowed to become unregulated by the Public Utility Commission. Electric cooperatives also had the option of opening their boundaries to competition after 2002. To date, PEC has not opted into competition. However, electric cooperative accounting policies and rate-making also ceased being regulated by the Public Utility Commission due to the passage of SB 7.

Although PEC is no longer regulated by the Public Utility Commission, PEC is subject to various bond indentures and mortgage note covenants that require a certain amount of liquidity and debt-service coverage that influences PEC's rates.[45] PEC's bond indenture and CFC mortgage notes have required it to keep rates at a level to produce an amount of net revenues sufficient to equate to a 1.15 times and 1.35 times debt-service coverage ratio, respectively. In the past ten years, PEC's debt-service coverage ratio has ranged from 1.32 to 2.46, but generally significantly higher than required. PEC's stated goals during this period were to maintain a debt-service coverage ratio of 1.50 or higher.

[44] Pedernales Electric Cooperative, Inc. Annual Report 2006.

[45] Pedernales Electric Cooperative, Inc. continues to maintain its general ledger in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC), as originally adopted by the Public Utility Commission. Pedernales Electric Cooperative, Inc. Annual Report 2006.

IV. Former Management/Management Practices

A. Background

Throughout the course of the class action lawsuit and ensuing criticisms from Cooperative members, the media, and other interested parties, questions were raised regarding the propriety of various financial transactions, expense items and business decisions by PEC's management and the Board. A central allegation in the class action lawsuit was management's and the Board's alleged failure to observe their fiduciary duties, as well as their alleged failure to operate the Cooperative in a prudent manner and primarily for the benefit of the Cooperative's members.

Inherent to these questions are questions regarding the organizational structure of PEC and lack of internal controls that may have allowed the alleged conduct to occur. As part of our efforts, we obtained an understanding and evaluated the effectiveness of former management's practices and the organization's internal controls, including the formal and informal policies and operating procedures of the Cooperative, the roles of management, and the overall tone established by former Senior Management in running the Cooperative.

1. Former Senior Management

While PEC's Board is generally charged with overseeing the management of PEC, the Board appoints a General Manager to conduct the day-to-day operations of the Cooperative. The General Manager of a cooperative essentially performs the duties of a chief executive officer.

The long-standing General Manager of the Cooperative, Mr. Bennie R. Fuelberg, was originally selected for that position by the Board in 1976. Mr. Fuelberg served in that capacity until his resignation in early 2008. As General Manager, Mr. Fuelberg answered directly to the Board. PEC's job description for General Manager states that the "primary purpose of PEC is to serve its consumers," which is the "main priority of every employee."[46] At the time of his resignation, effective March 6, 2008, Mr. Fuelberg had served as the General Manager of PEC for over 30 years.

Mr. W.W. "Bud" Burnett was a long-time Director on PEC's Board since 1968 and had served as the President of PEC's Board for over 30 years.[47] However, Mr. Burnett was also compensated as a full-time employee of PEC in the position of "Coordinator" since 1987.[48] The described role of the Coordinator was to "interface with legislative and regulatory bodies," with reporting responsibility directly to the Board. Mr. Burnett served in a dual role as Coordinator and Board President until his resignation from the Coordinator position effective November 30, 2007. Mr. Burnett subsequently resigned as Board President effective January 18, 2008.

[46] Pedernales Electric Cooperative, Inc., Job Title: General Manager, revised July 24, 1997.
[47] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., February 19, 1968.
[48] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 17, 1987.

Reporting to the former General Manager were two Assistant General Managers, Mr. Will Dahmann, and Ms. Jeanell Davis, each of whom had various administrative and operational responsibilities, as well as various Department managers at PEC's headquarters, and District managers resident in each of the Cooperative's seven District offices.

Mr. Will Dahmann was employed by PEC for approximately 29 years, most recently with the title of Assistant General Manager.[49] Prior to 1979, Mr. Dahmann worked for over 16 years at the LCRA, an entity which performed all of the daily operating activities for the Cooperative until those duties were assumed by PEC at the beginning of 1979.[50] Upon joining PEC, Mr. Dahmann served as System Operations Chief and Manager of the Operations and Engineering Division before assuming the position of PEC's Assistant General Manager in 1992. (Messrs. Fuelberg, Burnett and Dahmann are collectively referred to as "former Senior Management").

At the time of Navigant Consulting's retention, Ms. Jeanell Davis was, and remains, an Assistant General Manager at PEC. Ms. Davis has been in that position since May 6, 2006. Given her short tenure in a management position, our analysis focused primarily on the management practices of Messrs. Fuelberg, Burnett and Dahmann.

2. Organizational Structure

PEC's headquarters are located in Johnson City, Texas; these serve as the primary office location for the Cooperative's General Manager, Assistant General Managers and the various departmental functions (e.g., Finance, Human Resources, Engineering, Information Technology, etc.)

The Cooperative also has offices in each of its seven Districts. The District offices are semi-autonomous and decentralized in their function and decision-making with each having a manager who reports directly to the General Manager.

B. Work Performed

During the course of the investigation, we obtained an understanding as to the various management practices and business processes at PEC, including certain aspects of the control environment and activities related to those practices and processes. The roles of former Senior Management of the Cooperative were evaluated in relation to each relevant area of the investigation, including the former General Manager's responsibility for establishing and overseeing the internal control environment and control activities of the Cooperative, especially with regard to practices that raised concern among the Cooperative's members and other interested parties.

While a comprehensive evaluation and compliance review of PEC's internal controls is beyond the scope of this investigation, we nonetheless have observed various deficiencies in PEC's internal controls that we believe contributed to the Cooperative's problems. In addition, throughout this

[49] Payroll Change Request, Will Dahmann, listing the Date Employed as January 1, 1979.

[50] Payroll Change Request, Will Dahmann, listing the Date Employed as July 2, 1962, including reference to the transfer of LCRA employees to Pedernales Electric Cooperative, Inc., payroll effective December 31, 1978.

Report we highlight various management practices, business processes, functions and other procedures for which we believe additional controls were warranted both at the time of the investigation and going forward. These observations and associated recommendations are described in the relevant sections of this Report. Areas of work performed by Navigant Consulting as part of the investigation that also provided insight into the management practices and overall control environment at PEC during the period under investigation include the following:

- Reviewing Board Meeting minutes and Board packages including the information provided for the Board's evaluation and review regarding the Cooperative's policies, procedures, internal controls, as well as information useful in monitoring those controls.

- Reviewing Board resolutions regarding the Board's delegation of authority to management and/or committees in relation to certain aspects of the Cooperative's operations and associated controls.

- Evaluating the Cooperative's organizational structure and the reporting lines of its various business processes and functions, including segregation of duties and the Cooperative's practice of rotating managers between positions.

- Reviewing past organizational restructurings and business processes and functions for significant changes in relation to the Cooperative's control environment over time.

- Reviewing formal and informal management policies and operating procedures instituted at the Cooperative during the period under investigation, as well as those practices still in use at the Cooperative that were adopted in prior periods.

- Evaluating former Senior Management's philosophy and operating style, as well as the tone established by management in relation to the ethics of the organization.

- Evaluating the various identified management practices, policies, procedures and other internal control activities through the review of e-mails, internal correspondence, files maintained by the General Manager, and interviews of former and current Directors and employees.

- Evaluating the relevant financial and performance reports and other management practices and control metrics used in monitoring the Cooperative's adherence to certain policies and procedures, as well as various control activities established to ensure the effectiveness and efficiency of the Cooperative's operations.

C. Guidance on Internal Controls

Internal financial controls are systems of policies and procedures directed at achieving certain objectives of an organization, including effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations.[51] Internal controls occur throughout the organization at all levels and in all functions.

The scope of our work in this matter did not entail a comprehensive risk assessment of PEC's internal controls. Nevertheless, our observations and findings with regard to PEC's management practices, overall internal control environment, and certain control activities attempt to follow industry-accepted guidance on internal controls developed by The Committee of Sponsoring Organizations of the Treadway Commission ("COSO").[52] COSO has long-served as "the blueprint for establishing internal controls that promote efficiency, minimize risks, help ensure the reliability of financial statements, and comply with laws and regulations."[53]

Under the COSO guidelines, proper internal controls consist of five interrelated and equally important components including: *Control Environment, Risk Assessment, Control Activities, Information and Communication*, and *Monitoring*.[54]

The C*ontrol Environment* aspect of COSO pertains to such issues as the integrity and ethical values of management – particularly senior management, the Board's role in providing oversight, management's philosophy and operating style, the company's organizational structure, and the authority and responsibility granted to various parties. *Risk Assessment* relates to assessed risks affecting management in its achievement of specific financial reporting objectives, as well as the potential for material misstatement due to fraud. *Control Activities* are actions taken by an organization to address the identified risks including the establishment of policies and procedures. *Information and Communication* stresses the importance of identifying and capturing relevant information related to effectively implementing and carrying out the desired controls. The last component, *Monitoring*, ensures that the established controls are present and functioning.[55]

Our observations with regard to the management practices and internal controls at PEC are primarily focused on the areas of PEC's *Control Environment* including the integrity and ethical values of management, the Board's role in the control process, management's philosophy and operating style, and certain aspects of PEC's organizational structure that may have contributed to the observations and findings presented throughout this Report. To a lesser extent, we also observed PEC's established policies and procedures (or *Control Activities)*, as well as the *Information, Communication* and *Monitoring* of various management practices and controls at the Cooperative between and among management and the various PEC Districts and Departments.

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51 The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control – Integrated Framework*, 1992.

52 The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control – Integrated Framework*, 1992.

53 Tone at the Top, published by The Institute of Internal Auditors, Issue 28, November 2005.

54 The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control – Integrated Framework*, 1992.

55 Internal Control over Financial Reporting – Guidance for Smaller Public Companies, June 2006.

D. Observations and Findings

1. Integrity and Ethical Values – Tone-at-the-Top

Both the character of an organization and the management practices and overall control environment of the organization usually reflect the attitude and behavior of those who hold the senior management positions. As prompted by questions raised in connection with the class action lawsuit and as a result of criticisms of members and other interested parties, this Report addresses issues related to the management practices of the former General Manager.

The tone established by the former General Manager in running the Cooperative emphasized controls in many respects, as well as the penalties for failing to adhere to the policies and procedures he put in place. However, the internal control environment at PEC was fragmented, as well as decentralized in relation to Envision and the District offices, and was characterized by limited and inconsistent delegated authority, poorly communicated policies and procedures, and ineffective monitoring of certain of the controls that were in place. In addition, although the former General Manager was instrumental in establishing the policies, procedures, and related internal controls of the Cooperative, he also appears to have overridden some of those controls at his discretion.

Regardless of the controls in place, the practices actually adhered to are largely dependent on the culture of an organization, which for PEC were primarily established by the former General Manager. In any organization, concerns arise when (i) established controls in certain areas appear to be limited, fragmented, or poorly communicated; (ii) when it is difficult to ensure effective compliance; or (iii) when monitoring is insufficient to ascertain if proper procedures are being followed. At PEC, the former General Manager's hands-on and controlling management style enforced the compliance of lower level managers with the relevant aspects of the control structure he deemed important, even though that structure had significant deficiencies. The absence of effective controls created a number of problems at PEC as it size and complexity increased. Those problems are addressed further below.

2. Management's Philosophy and Operating Style

Management has primary responsibility for ensuring the effectiveness of an organization's internal control system. At PEC, the former General Manager exercised virtually complete control over PEC and its personnel during the period under investigation. As General Manager for over 30 years, Mr. Fuelberg had in-depth knowledge into most aspects of the Cooperative's business, including its operations, business processes and functions, contracts, personnel, and financial reporting.

The former General Manager was in a position to exert substantial influence over the Cooperative's structure of internal controls, and he clearly did so. He is credited with establishing most of the Cooperative's policies and procedures over the years, as well as having involvement in most decisions at the Cooperative.

The former General Manager's management style has been described as extremely hands-on and controlling, and authoritarian in nature. Anecdotal evidence gathered during the investigation indicates that his management style could also be abusive, especially with staff members whose opinions differed from his own, with those who questioned his authority, or with those who otherwise fell out of his good graces. Descriptions of Mr. Fuelberg's management style include various instances of employees, as well as Directors, being publicly confronted and chastised; employees being issued written reprimands, demoted and/or transferred to other roles, often with lesser standing; periodic and unannounced job rotations; personnel leaving on sabbatical only to find they had been replaced when they were set to return; and various Cooperative-wide policies issued by Mr. Fuelberg through informal memos to the Cooperative's managers. Mr. Fuelberg has been described as governing with an "iron-fist."

Throughout his tenure, the former General Manager's management philosophy was centered on customer satisfaction, a philosophy that was instilled in the Cooperative's management and employees, as evidenced by various individuals we interviewed during the investigation. Stated simply, the Cooperative's goals were to provide its members with unequaled customer service and access to reliable and affordable power. These goals were routinely reiterated in PEC's Annual Reports to its members:[56]

> *Since its beginning in 1938, the Cooperative has been committed to delivering reliable electricity, providing comprehensive customer service, and supporting the communities we serve. Each year membership grows, technology changes, and we make upgrades and investments that ensure we will deliver reliable service.*

Mr. Fuelberg's hands-on approach and in-depth knowledge of the Cooperative and its many functions had much to do with the Cooperative's success in conducting operations that were responsive to the needs of PEC's members as electricity consumers. PEC's significant past successes in customer satisfaction are evidenced by its performance in the annual J.D. Powers surveys which consistently ranked PEC number one in *customer service* over the past three years, top five in overall *customer satisfaction* (out of over 70 utilities in the medium-size utilities industry group), and top ten in *power quality and reliability* and *communication*s.

However, as suggested above, PEC's philosophy and focus on customer satisfaction appears to have been at the expense of sound fiscal controls within the Cooperative. We were told by various individuals during the investigation that the former General Manager emphasized customer service "regardless of the costs," often stating "do what it takes to serve the members." This management philosophy is also evidenced by an environment at PEC in which budgets often were nonexistent, expense controls were lax, and various expenses, especially of former Senior Management, went unquestioned. In some respects, the former General Manager's emphasis on service to the Cooperative's members regardless of cost fostered an environment in which cost controls, budgets, and expense management were secondary.

3. Organizational Structure

A company's organizational structure is important in supporting effective management practices, as well as the overall control environment established by the Board and management. PEC's historical

[56] Pedernales Electric Cooperative, Inc. Annual Report 2004.

organizational structure consisted of the former General Manager, with two Assistant General Managers, and various Departments and Districts.

PEC's organizational structure was relatively horizontal at the top, with all of PEC's Departments (i.e., Finance, Information Technology, Account Services, etc.) reporting directly to the General Manager, a feature that reflects Mr. Fuelberg's management style and his objective of maintaining direct control over most aspects of the Cooperative. While the District offices also reported primarily to the former General Manager, in many respects the day-to-day operations of the Districts were highly-decentralized, with discretion over various aspects of the financial and accounting processes (e.g., cash reconciliation, inventory) remaining in the hands of District managers.[57]

With the exception of the General Manager and the two Assistant General Managers (one described as being primarily tasked with special projects and the other having the responsibility to interface with the District offices on operational issues), there was a noticeable lack of other senior or executive management at the Cooperative during the period under investigation. The former Assistant General Manager of the Cooperative, Mr. Dahmann, was described primarily as performing special projects for the former General Manager and apparently had limited functional responsibility for the day-to-day operations of either the functional Departments or Districts. Mr. Burnett, although considered a part of former Senior Management, apparently had limited or no involvement with the day-to-day operations of the Cooperative. Mr. Burnett did not have an office at the Cooperative, had no staff, and had no functional or operational responsibilities that we were able to determine.

The Cooperative also had several Finance Managers and Legal Services Managers over time, but none were ever elevated to an "officer" position (i.e., Chief Financial Officer and General Counsel, respectively) with the associated roles and responsibilities of those titles. As an example, while the Finance Manager had control over the Finance Department and the processing of the Cooperative's various financial and accounting transactions, including the relevant financial reporting, the Finance Manager had only very limited authority to effect or monitor controls over various other aspects of the Cooperative including the payroll system (currently managed by Human Resources), the purchasing function (managed by Project Maintenance), or Envision, the software affiliate whose books and records were maintained separately and essentially outside the purview of the Finance Manager, among others.

The organizational structure of PEC may have been well-suited to the Cooperative's needs a number of years ago when it was a much smaller entity, at a time when a smaller array of functions and operations could be effectively managed by a hands-on, controlling management style. However, this management model is not well-suited to the much larger operation that PEC became over time. Three key characteristics of PEC's structure created constraints for the Cooperative as its size increased: (i) PEC's flat organizational structure, which created a wide span of control under the former General Manager; (ii) the fragmentation of functions into diverse departments that should be related and under the same authority; and (iii) limitations placed on interdepartmental control

[57] Responsibilities for overseeing operational aspects of the District offices were delegated to one of the Assistant General Managers, Ms. Davis, in May 2006, although the former General Manager appears to have continued to exercise significant control over the decision-making for many aspects of District operations.

functions. All of these resulted in an environment in which only the former General Manager had the knowledge necessary to make decisions and the primary responsibility for monitoring the Cooperative's systems of controls. This structural model also facilitated the overriding by the former General Manager of applicable controls, at his discretion.

4. Delegated Authority and Responsibility

In a typical organization, management and employees are delegated appropriate levels of authority and responsibility over their departments or functional areas, as well as authority to facilitate effective controls within those areas. The degree of delegation is also dependent on the employee's experience, knowledge, and competence in his or her area.

At PEC, managers were technically delegated authority to manage their respective Departments and Districts. However, in certain respects the former General Manager continued to maintain substantive personal control over the activities of the Departments and Districts; this control included limitations on the ability of managers' to independently address issues and develop solutions. It also included constraints on departmental managers' authority to deal with interdepartmental concerns, because the former General Manager is said to have strictly enforced a segregation of duties between Departments.

In addition, the former General Manager had a propensity to rotate managers among positions with some frequency. This practice is one that may foster diverse skills, but it may also result in a waste of expertise, and if not applied judiciously, may lead to reduced managerial competence and diminished ability of managers to effectively oversee the functions of the assigned District or Department. An example of this rotation is the transfer of the staff member, a licensed attorney, initially hired as PEC's Legal Services Manager, after a brief tenure in that function, to the Human Resources Department, and then his reassignment as Manager of the Information Technology Department.

In larger organizations, the responsibility for implementing and monitoring internal controls typically falls to the CFO and/or the Controller, who is responsible for internal controls over the organization's financial reporting, and to a General Counsel, who is typically responsible for internal controls over the organization's effective compliance with laws and regulations. In addition, many firms maintain an internal audit department and/or have a chief compliance officer. However, at PEC, the former General Manager narrowly focused the role of the Finance Manager and limited the function principally to the areas of transaction processing, financial reporting, and treasury, rather than allowing it to encompass the broader responsibilities typically played by a CFO, including oversight of the financial operations of the various other Departments, Districts and subsidiaries.

Likewise, the Legal Services Manager's role at PEC was limited primarily to overseeing certain aspects of the Cooperative's contracts, including pole attachment agreements and the administration of insurance renewals, rather than responsibilities partaking of the full function of a General Counsel (e.g., compliance with laws and regulations generally, organizational governance counseling, coordination and oversight of outside counsel services, and other tasks) . The limited roles and delegated authority and responsibility for these two positions within the Cooperative, as well as limitations placed on other managers, inhibited the effectiveness of the internal control structure at the Cooperative.

Another missing element of control for PEC during the investigation period was the Cooperative's lack of an internal audit function. An internal auditor is tasked with evaluating and monitoring the effectiveness of an organization's internal controls. However, to our knowledge, PEC has never had an employee who filled the functional role of an internal auditor, nor have any of its employees within the Finance Department been tasked with similar duties or responsibilities.

5. Policies and Procedures

Policies and operating procedures are typically established and communicated throughout the organization to ensure that operating practices are consistent across the organization and that reliable controls are in place. Policies and procedures cover a wide range of activities, including providing guidelines for employee conduct, limitations on authority, procedures for evaluating operating performance, and descriptions of overall responsibilities in various areas. PEC's controls appear to have been deficient in many of these areas.

Throughout the course of the investigation, we identified numerous formal and informal policies and procedures established over time, chiefly by the former General Manager. Yet the various Board resolutions, internal memoranda, and other more informal policies do not appear to have been consistently maintained, updated, or formally compiled into a comprehensive Cooperative-wide set of policies and procedures for ease of distribution and use by PEC's managers and employees. In addition, aside from the various policies regarding corporate conduct (e.g., nepotism policy, gratuities policy, etc.) the Cooperative does not appear to have had a formal written Code of Conduct establishing the Cooperative's primary controls that could have been routinely distributed to the Cooperative's employees in order to enhance communication and understanding of the Cooperative's policies.

With regard to financial controls during the period under investigation, it is our understanding that PEC did not make use of budgets, nor of comparisons of actual performance to budgets, for any aspect of its operations. Likewise, we noted that only limited versions of other financial controls existed in the areas of performance benchmarking and evaluation (e.g., benchmarking to competitive data), tracking of performance metrics and indicators, and functional reports by Department or District. PEC's various Departments and Districts thus had only limited tools available to assist in their decision-making, especially in relation to costs and expenses of the Cooperative.

PEC's Finance Department does produce certain functional reports for the Cooperative; however, its ability to produce reports by business unit at a more detailed expense level is limited by the Cooperative's current chart of accounts. A chart of accounts is the list of all account names and numbers used in PEC's general ledger. While the level of detail or specificity in a chart of accounts varies from one entity to another, PEC's chart of accounts generally follows the uniform system of accounts established by the Federal Energy Regulatory Commission that is generally used by electric cooperatives and other electric utilities. PEC's chart of accounts is somewhat simplistic, does not contain sub-accounts and currently prevents PEC from producing truly effective functional and expense reporting. As an example, PEC's chart of accounts does not provide for the separate tracking of certain types of administrative and general expenses, including meals and entertainment. The majority of travel expenses for PEC's former Senior Management were booked to an *Office Supplies* account, because in a normal utility chart of accounts that is where they are listed. However, most utilities supplement these accounts with a supplemental or sub-account type or account category (e.g., various sub-categories that would roll-up into the overall *Office Supplies* account). We understand that efforts were made by the PEC staff at various points in time to obtain former Senior Management approval to modify the Cooperative's chart of accounts in order to address the apparent deficiencies. These recommendations appear to have been overridden by the former General Manager each time.

PEC did relatively little benchmarking to competitors or tracking of its operations against performance metrics. Mr. Fuelberg was satisfied to gauge the Cooperative's performance on the criteria of growth, size, and overall customer satisfaction and reliability, as well as the maintenance of an AA- rating on its bonds. While enhancement of these characteristics was the professed goal of the Cooperative, there was an apparent lack of detailed evaluation and analysis of other performance metrics, especially with regard to various financial ratios, including metrics on the financial condition of the Cooperative and its ability to effectively manage its controllable expenses. The Board apparently was never presented with an analysis of this type, which could have allowed an objective assessment of the Cooperative's performance in financial and other areas.

6. Limited Available Financial Information

Reliable financial information is fundamental to planning, budgeting, pricing, evaluating vendor performance, assessing the value of subsidiaries, and a range of various other management activities relevant to those aspects of an organization's operations. In a typical organization, the roles and responsibilities of the finance department include developing entity-wide budgets and plans; routinely tracking and analyzing performance; providing functional reports from operational, compliance and reporting perspectives; as well as performing certain monitoring functions of the activities of various other departments and business functions. PEC's Finance Department appears to have been limited in many of these respects by the former General Manager.

As described, PEC performed little or no budgeting. PEC also does not appear to have historically evaluated vendor performance based on its experience with contracts, performed any sort of cost-of-service analysis internally to evaluate the relative costs in providing service to its customers, or prepared analyses on the merits, relative to the costs, of its operating subsidiaries (i.e., Envision and Texas Skies).

The limitations placed on the Cooperative by the lack of specificity in its chart of accounts, as well as the Cooperative's lack of focus on budgets or financial performance metrics, resulted in little useful information that would have allowed the relevant PEC Departments to identify, implement, and monitor effective business practices in their respective areas. As an example, until recently PEC had no routine procedure for supplying financial information to the District offices based on the costs incurred by each. PEC also had no procedure or functional reporting mechanism by which the performance of the District offices could be compared to one another. Likewise, we identified few reports evidencing controls related to administrative and general expenses, especially in relation to former Senior Management or Board expenses.

7. Lack of Effective Purchasing Function

Another significant deficiency observed during the investigation is PEC's lack of an integrated, Cooperative-wide purchasing function. PEC's purchasing function is primarily managed by PEC's Project Maintenance Department, and is not consistent with the purchasing function one would expect for an organization with the size and complexity of PEC. PEC has no consistent guidelines and controls with respect to which items must be processed through a purchase order and which should not. In addition, it is our understanding that PEC's purchase order system is not integrated with the Cooperative's J.D. Edwards accounting system, with the result that the standard reconciliation of invoices for items purchased back to the respective purchase order does not occur.

8. Internal Communication

Communication between an organization's senior management and managers, as well as interdepartmentally between managers, enables and supports understanding of the importance of management's practices, as well as of the overall business processes and associated controls employed to meet an organization's objectives. Contrary to this principle, communication within PEC was tightly controlled.

Throughout much of the period under investigation, PEC employees had limited use of e-mail or personal computers. Personal computers were not routinely provided to the Cooperative's managers until a few years ago and e-mail, where available, was discouraged as a form of business communication. In addition, PEC did not have a voice-mail system for use by managers and employees other than that used by the Cooperative's call center or those personnel with responsibility for interfacing with PEC's customers. Communication at the Cooperative was through less formal means and limited primarily to direct contact or telephone calls, and to the use of internal Cooperative memos.

In addition, informal communication between Department and District managers and their respective employees was discouraged. Managers were reportedly not allowed to have lunch or otherwise socialize with their employees. In addition, PEC had what was described as an "up and over policy" with regard to interdepartmental questions or concerns. PEC employees below the level of manager were not allowed to communicate directly with employees in other Departments without going through their immediate supervisor and "up" through the Department's manager, who would then communicate "over" to the other Department's manager and then down to the other employee.

The former General Manager communicated his expectations to the various managers and their respective Departments and Districts primarily through periodic meetings of the managers, as well as through periodic internal memoranda, which became the basis of PEC's ad hoc policies and procedures. One of the principal communication and monitoring tools of the former General Manager was by means of a small carbon-copy-based memo form referred to as a "buckslip." The manager meetings, internal memoranda, and buckslips appear to have been the former General

Manager's primary means of communicating policies and procedures, as well as in seeking information for purposes of monitoring adherence to these policies.

Effective communication also requires open channels of communication, including the willingness to listen and receive upward feedback. Based on our discussions with various Cooperative personnel, we understand that the culture at PEC was neither open nor conducive to effective communication. Many Cooperative employees we spoke with expressed having serious reservations over the years about the consequences of speaking out, especially in areas where their concerns might give the appearance that they were questioning either the policies or the authority of the former General Manager. What we learned from the employees was not dissimilar to what we were told by various Board members: Mr. Fuelberg was generally described as being unreceptive to the ideas of others, especially when they differed from his own opinions.

It is apparent that, as the Cooperative grew over time, a need existed for a more formalized approach in communicating both the expectations of management and the Board, as well as in communicating and monitoring established policies and procedures. As with other described aspects of the General Manager's management practices, his limitations on the use of computers, e-mails, and other types of communication effectively allowed him to maintain a high degree of control over the Cooperative and its managers. These intermittent and ineffective lines of communication also created significant barriers to the effective functioning of PEC's control environment.

9. Monitoring Management's Practices and Overall Controls

While the establishment of controls is of significant importance to an organization, the monitoring of the effectiveness of, and adherence to, controls is equally important. Within PEC, as with the establishment of controls, the monitoring role was primarily performed by the former General Manager. Mr. Fuelberg's deep experience at PEC and his single-minded focus on the Cooperative's service mission, coupled with his authoritarian methods, resulted in a certain amount of success based on his "top-down" monitoring role. Nevertheless, we believe the size of the Cooperative and the complexity of its operations ultimately required an internal control function at PEC of much broader scope than one individual could be expected to perform.

In enforcing significant segregation and fragmentation of duties of the various Departments, and in limiting the Finance Department and the Finance Manager's role in overseeing the activities of the various PEC Departments and Districts, including Envision, Mr. Fuelberg effectively hindered the monitoring of effective controls. In some instances, where individuals took it upon themselves to monitor certain aspects within other Departments or Districts, they were chastised for exceeding their authority and stepping outside of their defined roles and responsibilities. We heard several accounts of individuals being told by the former General Manager that it was not their responsibility to "police" others within the Cooperative.

The role of monitoring within the Cooperative was further hindered by the competence and objectivity of the relevant PEC Department and District managers. Competence is reflected by the knowledge and skills needed to perform assigned tasks. While the scope of our efforts did not entail assessing the capabilities of the various managers, their relative competence to effectively identify, implement and monitor controls in their respective departments was brought into question, given the former General Manager's propensity for transferring or rotating managers between positions within various Departments, or from the Headquarters location to one of the Districts.

The former General Manager encouraged and enforced a policy of job rotations among some of his managers. Citing the importance of cross-training, at times the General Manager would rotate certain of his managers from one department to another, including from one geographic location to another. While job rotations can be an effective tool in cross-training employees where needed, as well as an important tool in detecting and preventing fraud, the apparent benefits of the former General Manager's practice may have been outweighed by the inherent limitations such rotations placed on the effectiveness of the managers in their new positions, as well as the Cooperative's overall control environment.

Effective monitoring of internal controls requires the ability to identify deficiencies in those controls and to evaluate the root causes of control failures; these tasks in turn also require an in-depth understanding of the functional business areas and processes in which controls are implemented. However, while job rotations under the right circumstances are understandable, the forced job rotations at PEC often resulted in managers taking on new responsibilities with questionable competence in their newly assigned functional areas. Many of these transferred managers appeared, at least initially, to lack the technical knowledge and experience needed to effectively manage and monitor the relevant internal controls.

At the outset of our investigation, we noted various Department managers who had been placed in their current positions despite lacking the requisite background and experience that might be necessary to effectively manage their new Departments, or that might necessitate an extended learning curve. An example discussed earlier in this section involved an attorney hired by the Cooperative as a Legal Services Manager who was rotated into Human Resources and then to Information Technology. Another manager with a Computer Sciences degree and experience was placed in a role managing the Accounts Processing Department. Still other situations involved managers in charge of the Finance Department who were rotated to positions at another location in one of the Districts.

In some situations the rotations appear to have been motivated by a genuine interest in building effective managers within the Cooperative. However, others within the Cooperative also characterize the former General Manager's motivations as a means of punishment for various reasons, as well as a method of keeping managers in the Cooperative "off-balance" so as to preserve the former General Manager's effective control over the Cooperative and its policies.

Whatever benefits might be ascribed to the rotation policy that prevailed during the investigation period, in our assessment each rotation resulted in a period of increased risk to the Cooperative as individuals addressed the challenges associated with learning a new position. In addition, from a control environment perspective, individual managers often found themselves in new positions in areas where they may have had limited functional expertise, a factor that undoubtedly limited their ability to effectively identify, implement, and monitor the respective internal controls in their respective areas.

10. Board of Directors

A Board of Directors also has a fundamental role in monitoring the management practices and associated controls in an organization, especially in monitoring the actions and decisions of executive management. Monitoring by the Board becomes increasingly important with respect to controls that are at risk of being overridden by executive management.

As described in the following section of this Report, PEC's Board has a fundamental role in exercising oversight and responsibility related to the financial reporting and overall internal controls of the Cooperative. The effectiveness of a Board's oversight responsibility is dependent on various factors including the independence of the individual Directors, the experience and extent of the Board's involvement, the Board's scrutiny of management's actions and decision-making, as well as the appropriateness of those actions, and the willingness of the Board to address difficult and sensitive questions and issues with management.

PEC's Board appears to have had limited access to Cooperative employees other than the former General Manager and Board President. In addition, the tone established by the former General Manager with the Board appears to have discouraged inquiries and questions from the Board, especially in instances in which Board members expressed dissatisfaction or disagreement with the former General Manager's policies and opinions. In this regard, it is also noteworthy that the Cooperative's Finance Manager, effectively the Cooperative's senior financial official, had limited access to the Board during much of the period under investigation.

Typically, a Board's first and most-relied-on controls for review of transactions and other questionable items would be through the chief financial officer (CFO), general counsel and possibly the internal auditor of the company. However, during the period of investigation the role of the CFO effectively did not exist, nor did PEC have an in-house general counsel or internal auditor. The Board also did not have a separate audit committee, and the finance and accounting functions at PEC were limited by the former General Manager to primarily processing or support functions with limited emphasis on the overall control environment of the Cooperative.

Even in the absence of an internal auditor, general counsel, or functional CFO, the Board does not appear to have accepted its primary responsibility for oversight. As discussed in the following section of this Report, various aspects of the Cooperative's control environment, as well as the Board's oversight of those controls, were not effectively implemented. Apparent structural defects existed in the controls that no one undertook to remedy and which were never brought to the Board's attention. In short, no one was minding the store except the General Manager, and no one was minding the General Manager.

11. Summary

Internal financial controls are systems of policies and procedures that enable reliable financial reporting, promote compliance with laws and regulations and ensure effective and efficient operations.[58] Various aspects of PEC's internal financial controls were deficient in their ability to support these objectives for a number of reasons. First, PEC did not commit sufficient resources to the accounting and auditing functions, nor were the existing functions given an oversight role for various aspects of the accounting functions in the respective Departments and Districts or within the Envision subsidiary. Second, PEC also lacked comprehensive and formal policies and procedures. While we identified various policies at PEC, these were produced in an ad hoc fashion over time rather than in a well-documented and distributed manual for reference by relevant employees. Third, PEC did not comply with its own policies and procedures in certain areas, including with respect to former Senior Management expenses, because the process of policy compliance was marginalized by the former General Manager.

In addition, PEC lacked the necessary monitoring procedures to ensure that the Cooperative's policies and procedures were being followed effectively and that deficiencies were being identified and reported as needed. Monitoring procedures should be designed and implemented to provide information and reasonable assurance to management and the Board that the Cooperative's internal controls are effective, efficient, and otherwise functioning properly.

It is also apparent that the roles of other management-level employees (e.g., Assistant General Managers and the Finance Manager) were limited far more than was appropriate as a means of allowing the former General Manager to implement his own control over the Cooperative. In addition, while we did not find evidence that other management level employees significantly ignored their responsibilities, in many respects these managers failed to apply the appropriate level of scrutiny and make inquiry as to certain transactions. We were told that some employees that did ask questions were demoted or otherwise forced to leave, or were simply told "don't ask."

E. Recommendations

PEC's system of internal controls needs to be strengthened through additional resources, adoption of best practices and retention of personnel with substantial experience in the financial and internal audit areas. The most efficient and cost-effective way to implement and assess more effective internal controls over the operations and financial reporting of the Cooperative is to build a more effective control-centric culture at the Cooperative, including through the delegation of substantive responsibility for establishing and monitoring control activities to appropriate senior management positions, as well as through the establishment of an internal audit-minded function in the Cooperative.

While the former General Manager exhibited authoritarian control over the Cooperative, the failure to delegate effective control to Department managers, the largely decentralized control over the Districts, the lack of formalized policies, ineffective communication of those policies and procedures, and limited monitoring of the Cooperative's compliance with those policies and procedures, have hindered the development of a proper control-oriented environment at PEC.

[58] The Committee of Sponsoring Organization's of the Treadway Commission (COSO), *Internal Control – Integrated Framework*, 1992

Many of the observed deficiencies in the Cooperative's management practices and overall control environment, including deficiencies in individual control activities, are highlighted throughout the Report. However, certain fundamental changes that are recommended to strengthen the overall control environment and enhance both the Board's and management's responsibilities for oversight include the following:

Chief Financial Officer

- During the period under investigation, it was noted that somewhat common senior management positions were effectively absent from PEC including a chief financial officer (CFO) and in-house General Counsel, whose responsibilities, in part, typically include monitoring the compliance of senior management with applicable laws and regulations, as well as adherence to the corporation's policies and procedures, and other financial controls.

- Navigant Consulting acknowledges that the new PEC General Manager, Mr. Garza, elevated the position of the former PEC Finance Manager to that of CFO, with all of the associated authority and responsibility over the financial operations and reporting of the Cooperative. We consider this action to be appropriate and would further recommend that the new CFO be evaluated for a period of time to ensure he has the requisite skills and experience to effectively serve in his new role, including an understanding as to what that role entails.

General Counsel

- Navigant Consulting also acknowledges that the new PEC General Manager promoted an internal PEC employee, who is also an attorney, to the position of interim General Counsel. As with the newly appointed CFO, Navigant Consulting considers this action to be appropriate and we recommend that the interim General Counsel be evaluated for a period of time to ensure he has the requisite skills and experience required of the position, as well as what the specific demands of the position are in relation to PEC's needs.

- New management also retained an attorney to serve as in-house Corporate Governance Counsel. While we are not aware of the distinction between the anticipated role to be played by the interim General Counsel and that of the in-house Corporate Governance Counsel, or the anticipated lines of reporting, we consider the steps taken by new management to be appropriate in light of the significant issues and challenges facing PEC in addressing various issues in its internal oversight and governance responsibilities. We would recommend that the effective roles between the in-house General Counsel and the Corporate Governance Counsel be well-defined and that clear reporting responsibilities be established to avoid confusion over the responsibilities of each in serving the needs of the Cooperative and its members.

Internal Audit Function

- PEC's system of internal controls needs to be strengthened through additional resources, adoption of best practices and retention of personnel with substantial experience in the financial and internal audit areas. It is recommended that PEC establish an internal audit function either as a separate Department, or a separate function of the Finance Department, and vest the position with the authority to establish procedural and policy reviews of various financial reporting related activities across the Cooperative.

- It is recommended that the established position have access and the ability to report to the Board's Audit Committee on matters deemed appropriate for their consideration, and that the Board Audit Committee have input into the planning of the scope and areas for review throughout the year.

Organizational Structure

- Given PEC's relatively horizontal organizational structure, and the associated limitations such structure places on an effective control environment, it is recommended that PEC evaluate revising its organizational structure to include additional executive level positions (Chief Financial Officer and General Counsel).

- In addition, it is recommended that PEC evaluate its organizational structure with regard to establishing appropriate lines of reporting and delegation of authority, rather than the past structure where essentially all Department and District managers effectively reported to the General Manager.

- Toward this objective, at the direction of new management, it is important to note that PEC has already implemented a formal review of its organizational structure, which is addressed in more detail in another section of this Report (i.e., *Operational Review and Evaluation*).

Policies and Procedures

- PEC's current policies and procedures consist of various standardized polices, Board resolutions, internal memoranda, and informal "buckslips" created over the years. However, they do not appear to have been consolidated into a comprehensive policy and procedures manual, nor do they appear to have been evaluated for relevance and consistency. It is recommended that PEC undertake to compile and consolidate the Cooperative's various formal and informal policies and procedures into an electronic manual with ready access by the employees of the Cooperative. During this process, it is also recommended that PEC undertake a systematic review of the current applicability of the identified policies and procedures and their effectiveness as control activities.

Functional Reporting by Business Unit and District

- At present the Cooperative has limited functional reports by Department or District (i.e., Business Unit) and limited capability to compare the various operational aspects of Departments or Districts to one another. It is recommended that the Finance Department create additional functional reports by Business Unit to address needed oversight on administrative and general expenses, as well as various discretionary expenses incurred at the Department and District levels.

General Ledger Chart of Accounts

- The usefulness of functional reporting by Business Unit and District is limited by the specificity inherent to the Cooperative's chart of accounts. Although based on FERC accounting, it is recommended that PEC adopt more detailed reporting capability under its chart of accounts by adding additional specificity and sub-accounts where needed.

Budgets/Forecasts

- The Cooperative currently makes no use of budgets, and only limited use of financial forecasts, especially in relation to variance reporting where actual results differ from budgeted or forecasted expectations. At a minimum, it is recommended that the Cooperative create variance reporting in various controllable expense areas, especially where expenses are significantly discretionary in nature or where significant ongoing expenditures are expected (e.g., line maintenance, technology costs, consulting fees, etc.).

Capital Expenditure Forecasting/Prioritization/Allocation

- The Cooperative currently uses no process to determine the level of capital expenditures that current rates and revenues can support, and has no formal process for establishing targets of capital investment, nor a process for prioritization of projects considered to be necessary. It is recommended that the Cooperative adopt a rigorous financial forecasting process to determine the level of capital expenditure targets that should be adopted and a basis for allocation of available capital expenditure dollars to necessary projects.

V. Board of Directors – Governance Structure

A. Background

1. Structure of the Board

The business and affairs of PEC are managed by the Board of Directors, consisting of a Director from each of the Cooperative's seven districts.[59] PEC's Bylaws also provide for an Advisory Director to be elected from each of the Cooperative's seven districts.[60] The Advisory Directors do not have the right to vote on Board matters. Pursuant to the Bylaws, their function is to "perform such duties as may be prescribed" to them by the Board of Directors.

The Bylaws of PEC also provide for up to four Advisory Directors-at-large, who may be appointed by the Board of Directors. As with the Advisory Directors, the Advisory Directors-at-large do not have the right to vote on Board matters, but are available to perform duties prescribed by the Board.

2. Election of Directors

Members of the Board of Directors, with the exception of the Advisory Directors-at-large, are elected by the membership. Directors and Advisory Directors are elected at the Cooperative's Annual Meetings and serve for terms of three years or until their successors are elected. The Directors have "staggered terms" so that the terms of either two or three Directors expire each year. A Director may serve multiple terms if so elected by the members. While Advisory Directors-at-large are appointed by the Board, they also serve for a term of three years, or until their successors are appointed.

3. General Powers of the Board

Pursuant to the Cooperative's Bylaws, the Board is vested with "all of the powers of the Cooperative" except those reserved to the members.[61] More specifically, the Board has the power "to make and adopt such rules and regulations…as it may deem advisable for the management, administration, and regulation of the business affairs of the Cooperative."[62] The Directors set policies to guide the General Manager, who operates the Cooperative with a staff of employees. As a member-owned electric cooperative, PEC is self-regulated with respect to the setting of its retail electric rates for both energy and distribution services.

4. Board Meetings/Workshops

The Board meets regularly each month, as well as immediately following the Annual Meeting. In addition, the President of the Board or any four voting Directors of the Board may call a special

[59] Bylaws of Pedernales Electric Cooperative, Inc., Article III, Section 1. The Bylaws were amended January 31, 2008, but no change was made in the provisions discussed in this section of the report.
[60] Bylaws of Pedernales Electric Cooperative, Inc., amended January 31, 2008.
[61] Bylaws of Pedernales Electric Cooperative, Inc., amended January 31, 2008.
[62] Bylaws of Pedernales Electric Cooperative, Inc., amended January 31, 2008.

meeting of the Board at any time, subject to providing the required notices. In addition, throughout much of the period under investigation, PEC routinely held off-site workshops for the Directors that were outside the normal Board meeting process. The Board workshops appear to have averaged about two per year, with the exception of 2007 when five workshops were held (reportedly as a result of the class action lawsuit). The Board workshops were non-voting meetings that typically focused on one or more special issues for the Board to review. The workshops were typically held at remote locations with the majority appearing to have taken place in or around San Antonio, Texas.

5. Board Compensation

Pursuant to the Cooperative's Bylaws, a Board member is paid a fixed sum and reasonable expenses for attendance at each regular meeting of the Board. A Board member is also paid a fixed monthly sum and reasonable expenses for participation in other meetings, outside of regular Board meetings.

6. Board Conferences and Training

Board members have routinely participated in certain industry and trade association-sponsored conferences and training seminars held several times a year at various locations throughout the United States. Principal sponsors of these events have typically included the National Rural Electric Cooperative Association ("NRECA"), the national service organization representing the interests of cooperative electric utilities, and Texas Electric Cooperatives ("TEC"), the state-wide trade association for Texas electric cooperatives.

Board members are also encouraged to participate in various training courses offered by the cooperative associations (e.g., NRECA and TEC). PEC has historically compensated Board members for attendance at such training sessions, as well as paid for the cost of the course and course materials. However, a Board member's participation, as well as the choice of what courses in which to participate, has been typically left up to the discretion of each individual Board member.

B. Work Performed

The Board's role in providing direction and oversight in the management of the Cooperative was evaluated in relation to each area of the investigation, including its role in connection with certain practices that raised concern among the Cooperative's members and other interested parties.

1. Board Minute/Board Package Review and Evaluation

With regard to each area of the investigation outlined below, Navigant Consulting reviewed minutes of the regular and special meetings in connection with the respective discussion, decision and/or delegation of authority relative to the actions under review. In addition, we evaluated the supplemental material provided to the Directors in advance of each Board meeting that comprised the "Board package" in order to identify the information provided in support of each action/decision and whether the Board had been provided reasonable information, or was otherwise reasonably informed, as to the issues that may have had bearing on its decision-making.

2. Interviews with Current and Former Board Members

Interviews were conducted with a number, but not all, of the current and former Board members. We attempted to gain a general understanding regarding the functioning of the Board, the collective decision-making process, the information provided to the Board in connection with various resolutions, and the Board's efforts to become informed as to the issues in question, as well as to act in the best interests of the Cooperative. The investigation period covered ten years, and in some cases, the interviewed Board members had only general recollections about many of the facts in question.

Six Board members were interviewed by Navigant Consulting in connection with its information-gathering process – Messrs. E. B. Price, O. C. Harmon, Val Smith, Barry Adair and Ms. Vi Cloud, who were Voting Directors at PEC during the period under investigation, and Ms. Libby Linebarger, who was an Advisory Director-at-large during the period under investigation – Ms. Cloud, Mr. Harmon, and Mr. Smith are presently voting members on the Board.[63] Navigant attempted to interview the other Directors, including the remaining Directors, Advisory Directors, and Advisory Directors-at-large that were on PEC's Board during the period under investigation. However, the remaining Directors declined, through counsel, to be interviewed without certain preconditions that the investigative team was unwilling to accommodate.

3. Evaluation of Board Delegation of Authority

In addition to understanding the Board decision-making process, we also evaluated the various powers of the Board for the management of the business and affairs of the Cooperative (as prescribed in the Bylaws) that the Board may have delegated to either a committee of the Board or to former Senior Management.

4. Analysis of Board Compensation/Benefits and Expenses

An initial area of inquiry in connection with the investigation related to an analysis of the compensation, benefits and expenses paid and/or provided to the Board during the period under investigation. The results of Navigant Consulting's analysis of Board compensation, benefits and expenses is included in subsequent sections of the Report (i.e., *Director Compensation and Benefits* and *Director Expenses/Expense Reimbursement*).

5. Evaluation of Board-Related/Affiliated Entities in Relation to PEC

To evaluate potential conflicts of interest that may have existed, Navigant Consulting evaluated relationships between (i) the Board members and any related or affiliated parties of Board members during their respective tenures as Directors, and (ii) PEC or PEC-related parties, in each case during the period under investigation. The results of Navigant Consulting's investigation into Board-related

[63] Mr. Adair was interviewed via telephone. He was a Voting Director during only a portion of the period under investigation (i.e., since May 2005).

parties and affiliated entities are also addressed in a subsequent section of the Report (i.e., *Other Related Parties and Affiliated Entities*).

C. Observations and Findings

1. General Board Duties/Responsibilities

The Board of Directors of a corporation oversees the operations of that corporation in such a manner as to assure effective and sound management. As part of its governance role, a Board's general function is to provide oversight, set strategy, and monitor the effectiveness of the organization's internal controls, while a chief executive officer or General Manager is responsible for the corporation's day-to-day operations. Similarly, under PEC's Bylaws, the Board is charged with "managing the business and affairs of the Cooperative."[64]

In guiding the direction of a cooperative, Director responsibility also has been described to include:[65]

- Preserving the character of the cooperative – keeping the cooperative focused on how it must operate.
- Safeguarding the assets of the cooperative – making sound business decisions and increasing the cooperative's value by producing additional benefits to its members.
- Setting policies of the cooperative – originating and approving general policies that relate to the cooperative's functions and how it conducts business. The policies should cover internal and external activities and serve as the basis for making consistent decisions that minimize conflict and maximize accountability.

Boards of Directors have a responsibility to act in the best interests of the organization they serve and must put their duty to the organization before their individual and private interests. Board members are expected to exercise sound judgment and care in overseeing the organization's business and in resolving problems facing the organization, including exercising a duty of care when making decisions, decisions that an ordinarily prudent person would make under similar circumstances.

2. Board Authority/Decision-Making

During the course of our work, we have identified few resolutions, policies or procedures that address or interpret the general language of the Bylaws regarding the respective powers of the former General Manager and the Board.[66] While various items were brought to the Board for approval, we have identified no guidelines specifying what items the Board determined to be within

[64] Bylaws of Pedernales Electric Cooperative, Inc., Article III, section 1, amended January 31, 2008; and Texas Utilities Code section 161.071.

[65] Cooperatives: What They Are and the role of Members, Directors, Managers, and Employees, United States Department of Agriculture, Rural Business Cooperative Service, RBS Cooperative Information Report 11.

[66] "The business and affairs of the Cooperative shall be managed by a Board…" Bylaws of Pedernales Electric Cooperative, Inc., Article III, section 1, amended January 31, 2008.

the scope of its authority in contrast to those within the express or delegated authority of the General Manager.

We identified only limited instances during the past ten years in which the authority of the Board was delegated to a committee of the Board, either for action, for study, or for development and reporting to the full Board. In addition, and primarily in the most recent years, the Board appears to have provided Mr. Fuelberg certain poorly-defined blanket authority over various aspects of the Cooperative's business. In 2004, Mr. Fuelberg was given authority, along with Mr. Dahmann, "to execute instruments of any nature as necessary on behalf of" PEC.[67] While blanket authorizations in relation to the management of an organization's day-to-day activities are not uncommon, they are usually approved with some limitations, e.g., execution of instruments "in the ordinary course of the organization's business." In 2005, the Board authorized Mr. Fuelberg "to make any other provisions as deemed necessary;" while this directive, made in the context of a Board meeting, was presumably in relation to the election of officers, it is nonetheless not clear, and is exceptionally broad.[68]

Even Board resolutions that appeared to provide some limit on Mr. Fuelberg's authority were often overridden by other resolutions granting Mr. Fuelberg authority to act as he deemed necessary. As an example, while the Board would annually grant a certain amount to be distributed to PEC employees and managers for merit pay increases and promotions, the Board would in turn delegate authority to Mr. Fuelberg to retain all other employees at his own discretion, including giving him the blanket authority to make one-time special payments or merit increases at his discretion.

Even with respect to items on which the Board to voted, the outcome often appears to have been pre-determined or effectively constituted a foregone conclusion, because the contract or action in question had already been executed or approved by the former General Manager. Many of the Board resolutions are more appropriately described as Board ratifications of management's actions rather than approval of actions to be taken. In addition, many items brought before the Board for approval were items the General Manager likely had authority to approve without the Board's involvement. This mix of policy-related and non-policy related approvals might have had the effect of further blurring for the Board the distinction between their true function and that of their General Manager.

A Board's ability to reserve authority to itself for certain key decisions is one its most fundamental powers in maintaining effective oversight of the corporation, as well as its ability to ensure that appropriate controls exist within the corporation, including controls over the actions and decisions of senior management. However, a perception shared by certain Directors we interviewed was that Mr. Fuelberg essentially had authority to do whatever he wanted, which is consistent with our understanding as to the Board's relatively passive role during the period under investigation.

3. Control Over the Board by the Former General Manager

Whether or not acknowledged by the Board members, the Board appears to have placed almost complete reliance on the former General Manager, Mr. Fuelberg, to establish the strategic direction

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[67] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., September 20, 2004.

[68] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 18, 2005.

for the Cooperative, to set the policies and procedures by which it was governed, and to provide the benchmarks for how the Cooperative's performance was to be measured and evaluated. During Mr. Fuelberg's tenure as General Manager, he, rather than the Board, appears to have exercised the most control over the formulation of policy and key decision-making that normally should have been reserved for the Board. Based on information available during the investigation, almost none of the key policy decisions affecting PEC's operations appear to have been initiated by, or significantly influenced by, deliberations or decisions of Board members, including decisions regarding the Texland venture, Board and former Senior Management compensation and expenditure policies, the acquisition and continued funding of the Envision subsidiary, and the acquisition of the Kimble Electric Cooperative, among others.

Mr. Fuelberg appears to have maintained his control by a number of means, including his influence over the former Board President (Mr. W.W. "Bud" Burnett), who was also a PEC employee; through his relationship with PEC's outside General Counsel (A.W. Moursund and his successor The Moursund Law Firm); through apparently unlimited delegated authority obtained from the Board; through his efforts to control both the Board agenda and topics for discussion; and through his limiting the Board's access to information and his ability to discourage and/or silence opposing views and opinions by intimidation. The Board members were compensated well and continued to hold Directorship positions that were associated with a certain degree of respect and prestige in the PEC service area.

A critical factor that contributed significantly to the Board's acceptance of Mr. Fuelberg's role was the Board's general consensus that Mr. Fuelberg was a talented manager who had presided successfully over years of significant growth of the Cooperative. The basis for the Board's perception was due to the Cooperative's successful growth, as well as the high marks the Cooperative achieved in customer satisfaction, and the Cooperative's successful efforts to improve reliability.[69] The Board, over time, appears to have yielded, or continued to allow, significant authority to the former General Manager in management of the financial, administrative, and regulatory affairs of the Cooperative.

In addition to Mr. Fuelberg's dominant role, it appears that significant influence was also exercised by PEC's outside General Counsel. We were told that A. W. Moursund exercised significant influence and control over Mr. Fuelberg, as well as Mr. Burnett, and to some extent over the PEC Board, particularly during the early years of Mr. Fuelberg's tenure as General Manager. A.W. Moursund's authority apparently declined in relation to Mr. Fuelberg's authority over time. Upon A.W. Moursund's death in 2002, the responsibilities of General Counsel were nominally passed on to his son, Will Moursund, and the Moursund Law Firm. Although the long-standing relationship between the Cooperative and the Moursund family thereafter continued until it was terminated by PEC's new management in mid-2008, the level of influence exercised by Will Moursund and the Moursund Law Firm over PEC does not appear to have been as significant as that exercised by A. W. Moursund during his lifetime.

[69] J.D. Power and Associates, Electric Utility Residential Customer Satisfaction Studies: 2005, 2006 and 2007, *Overall Customer Satisfaction Index* and *Power Quality and Reliability*.

4. Board President as an Employee of the Cooperative

Mr. Burnett served on PEC's Board for nearly 40 years, and was Board President for over 30 years. In 1987 he also became a full-time employee of the Cooperative with the title "Coordinator." The Coordinator role was a position created by the Cooperative with the described purpose of interfacing with legislative and regulatory bodies. The Cooperative's Bylaws were also amended at that time to provide for the Coordinator position and its holder's compensation as both an employee and a Board member. Mr. Burnett's annual salary was set at $60,000 with full benefits, a compensation amount consistent with that for a full-time manager of the Cooperative at the time.

The August 1987 Board resolution authorizing the hiring of Mr. Burnett does not provide details as to the rationale for Mr. Burnett's hire; nor does it shed light on the reason for the unusual dual character of Mr. Burnett's status as the Board President and as an employee of the Cooperative, two roles that might be perceived to have elements of conflicting interest. A number of Directors serving on the Board during much of Mr. Burnett's tenure as Board President and as a Cooperative employee also could provide little additional explanation regarding the justification for Mr. Burnett's Coordinator position with the Cooperative at the time of his hiring, or during the years of his tenure.

Although in his position as Coordinator Mr. Burnett reported directly to the Board, as a salaried employee of the Cooperative, Mr. Burnett was subject to the influence of the Cooperative's former General Manager, Mr. Fuelberg, who was in a position to exercise influence over Mr. Burnett both in his role as Coordinator and as Board President. Mr. Burnett's status as an employee of PEC, under Mr. Fuelberg's supervision, created potential to impair Mr. Burnett's independent judgment in his role as a Director.

Mr. Burnett was highly compensated for his service as a Board member and as an employee of the Cooperative, and he had a significant amount to lose if his decisions and opinions were in conflict with Mr. Fuelberg's. While we have identified no direct evidence to support the contention that Mr. Burnett's judgment was materially or adversely affected by his relationship with Mr. Fuelberg, or through the authority Mr. Fuelberg held over him as an employee of the Cooperative, Mr. Burnett nonetheless was in a position to exercise significant influence as a Voting Director and Board President over the Board's policies and decision-making for nearly 40 years.

As the term is currently understood, we believe that Mr. Burnett would not be considered an "independent Director" under generally accepted standards; and prevailing governance principles would recommend, if not require, that certain Board decisions be reserved for decision only by independent Directors.[70] By virtue of a recent amendment to PEC's Bylaws, Mr. Burnett would no longer be qualified to serve as both an employee and Director of the Cooperative.[71]

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[70] Sarbanes Oxley Act of 2002, NYSE Rule 303A, NASDAQ Rule 4350.

[71] Bylaws of Pedernales Electric Cooperative, Inc., Article III, section 2(c), revised November 13, 2007 and January 31, 2008. The Bylaws now provide that a director may not be a current or former employee of the Cooperative.

In the wake of the class action lawsuit and public discourse surrounding information that came to light regarding Mr. Fuelberg's tenure as General Manager, Mr. Burnett resigned his position as Coordinator at the end of 2007, and then from the Board in early 2008.

5. Communications with the Board

While we generally understand that Mr. Fuelberg would invite one manager to the "open" Board meeting each month, the general feeling among PEC managers was that Mr. Fuelberg controlled and limited their access to the Board. Throughout our interviews with current and former PEC employees and Directors, the relative disconnect between concerns common to PEC managers and employees versus what was understood by the Directors was evident. While it generally is not considered good practice for Directors to have unlimited access to a corporation's employees, rather than relying on communications through senior management, the apparent filtered and limited information provided to PEC's Board by the former General Manager was insufficient to fully apprise the Directors of facts they deserved to know. Certain of these facts included the costs of the Texland venture and its continued maintenance as a corporate entity; the existence of the Texland bank account at Cattleman's; the detailed costs, strategic dilemmas and failures of the Envision subsidiary to successfully market its product to third parties; and pervasive concerns among PEC employees related to certain management practices of the former General Manager, as well as various other matters.

Many of the current and former Directors hold the opinion that Mr. Fuelberg was a brilliant and successful General Manager, and that all was well within the day-to-day lives of the Cooperative and its employees. However, during the course of our investigation we encountered significant resentment by PEC employees toward the management practices employed by Mr. Fuelberg during his tenure. While it is not unexpected in investigations of this nature to encounter current and former employees who believe that they have been treated unfairly, the extent and depth of such concerns within the Cooperative are noteworthy, especially in light of the Board's limited awareness of the expressed concerns. Many of the employees we interviewed who held such concerns did not believe they had any avenue or access to the Board to inform it of their concerns or to seek potential redress.

6. Board Committee Use

Appropriate delegation of specific functions to Board committees is becoming increasingly important as a way to enhance the productivity of a Board. Effective structuring, delegation of authority and efficient use of committees can allow a Board to cover a wider range of issues with a greater depth.

While the use of Board committees is not required, and the absence of such committees, especially in smaller cooperatives and corporations, is not uncommon, it is noteworthy that a corporation the size of PEC did not make use, for practical purposes, of Board committees. Given the challenges facing a rapidly growing Cooperative such as PEC, including capital investment decisions, financing decisions, dynamic wholesale power costs, compensation and personnel matters, rapidly changing technology and costs, and other challenges, we believe that an engaged Board would have made more use of standing committees to assist in its decisions.

7. Board Atmosphere – Tone

Important for any Board is the tone established by management in the day-to-day operations of the organization. The so-called "tone-at-the-top" establishes the environment in which the organization is administered and influences the policies, procedures and decision-making in the organization, including the transparency that characterizes the deliberative process, and the presence of checks-and-balances against abusive or inappropriate practices that may place an organization at risk.

The tone established by the former General Manager in managing the Cooperative was discussed in a previous section of this Report (i.e., *Former Management and Management Practices*). As with the employees of the Cooperative, the former General Manager also established a clear tone in his dealings with the PEC Board. In essence, Mr. Fuelberg's dealings with the Board appear to have been similar to his interactions with the Cooperative's managers; he apparently was not receptive to opposing views or opinions, and it was not uncommon for him to publicly confront those who challenged his views. Based on Navigant Consulting's interviews with various Directors, it was evident that Mr. Fuelberg's "command and control" approach was effective in influencing the Board to adopt his views. Mr. Fuelberg's method of dealing with the PEC Board, combined with his control over the content and dispersal of information to the Board, limited the Board's ability to effectively oversee Mr. Fuelberg's decisions.

Some Board members generally acknowledged that Mr. Fuelberg did not seek input from the Board in decision-making and generally did not listen to the opinions of the Board. While some Board members have apparent misgivings about not requesting or demanding more information affecting certain decisions, they also have vivid memories of Mr. Fuelberg's intimidating management style in action, and they believe that any significant opposition to Mr. Fuelberg would have been met by their ultimate removal from the Board.

8. Lack of Information

The Board had a responsibility to insist on receiving adequate information. An evaluation of the past Board meetings, packages and minutes reveals that Mr. Fuelberg essentially controlled the agenda brought before the Board each month, unilaterally making decisions on what should or should not be provided to the Board and/or discussed at the meetings. The common process was for Mr. Fuelberg to solicit information from the various PEC departments each month in a format prescribed by him. He would then determine what information would be presented to the Board and how it was to be organized. Neither the Board President nor any other Director appeared to have any input into the Board agenda and items presented in the Board package.

The Board's limited access to outside consultants, reports, or studies to assist the Board in its decision process, as well as the apparent lack of information provided to them, especially in connection with some of the larger decisions and capital outlays by the Cooperative over the years (e.g., Envision, Texas Skies, the Kimble acquisition, PEC's consideration of participation in retail competition in 2002, and the 2002 bond offering) is noteworthy. Many of the Board's decisions appear to have been made without adequate information, consideration or deliberation. In certain instances it appears that the Board may have been denied important information, while in others information appears to have been presented in the light most supportive of management's viewpoint, with both instances resulting in a Board that may not have fully appreciated the significance of some of the issues that came before it for consideration. As an example, it is our understanding that the Board approved the Cooperative's bond offering in 2002 after a brief telephonic meeting of the Board, without looking at the financial forecasts of the potential costs and impact to the Cooperative.[72]

Based on the limited information presented to the Board by PEC former Senior Management, it might have been natural for the Board to assume that matters at PEC were generally going well. However, throughout Mr. Fuelberg's tenure, a number of serious issues were raised that should have prompted detailed questions from the Board, if not an external review by independent parties. Principal among these were the handling of Texland, the staged acquisition and subsequent funding of the Envision software subsidiary, the acquisition of Kimble Electric Cooperative, Inc., the Cooperative's ongoing relationship and potential conflicts with the Moursund family, and various financial issues including the Cooperative's source of funding and decisions regarding the setting of rates.

As a further example, the full Board, on various occasions, agreed to compensation requests from Mr. Fuelberg, apparently without engaging in its own analysis of the reasonableness of those requests. Specifically, the conversion of Messrs. Fuelberg's, Burnett's and Moursund's bonuses to salary in 2001 occurred without any apparent discussion; many of the Board members who were present cannot recall adding $60,000 per year to these salaries. In addition, the Board's agreement to adjust Messrs. Fuelberg's and Burnett's salaries on multiple occasions during the 2001 – 2002 time period appeared to raise few questions, and appears to have been approved with little independent analysis or deliberation. The minutes of the Board meetings give no indication that the Board at the time significantly discussed, or evaluated, the reasonableness of Mr. Fuelberg's requests.

9. Board Complacency and Failure to Act

In many instances it appears the Board failed to properly oversee the former General Manager and properly address potential conflicts of interest. The involvement of the General Manager, PEC's General Counsel (i.e., A.W. Moursund or The Moursund Law Firm) and outside counsel (i.e., Clark Thomas) in decision-making in some respects appears to have given the Board some comfort in presuming that the various transactions and management actions that the Board was asked to approve were in the Cooperative's best interests. Of course, none of these parties could perform the Board's role of deliberating and deciding policy matters related to the Cooperative's business decisions.

10. Board Election Process

The Board election process was primarily controlled by incumbent Voting Directors and by Messrs. Fuelberg, Burnett, and A.W. Moursund. The Board used a "nominating committee" comprised of one representative from each of the Cooperative's seven Districts, as designated by the Voting Director in that District. At a Board meeting a few months before the Cooperative's Annual Meeting, the nominating committee would meet and nominate Directors for the vacant positions. The

[72] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 28, 2002.

nominating committee would nominate one individual for each position, which was subsequently presented to the members at the Annual Meeting for approval.

While the use of nominating committees by Boards of Directors is not uncommon, PEC's nominating committees over the years consisted of many of the same individuals, including certain related parties; consistently nominated the existing Directors for continued service; and did not once recommend putting more than one candidate for each position to the vote of the members at the Annual Meeting. In many respects, the choices for PEC's Board positions appear to have been pre-determined, which were then subsequently formally "nominated" by the nominating committee. In addition, PEC's Bylaws made no provision for term limits, thus allowing some incumbent Directors to be re-elected under this process for consecutive terms over the course of many years.

11. Board Use of Performance Metrics

The Board allowed the Cooperative's former General Manager to establish the metrics by which he wanted the Cooperative, as well as himself, to be judged (e.g., customer service and reliability) and essentially ignored many aspects of the Cooperative's financial performance and whether the Cooperative's spending was fiscally responsible and in the best interests of the Cooperative and its members. Regardless of Mr. Fuelberg's proficiency in achieving customer satisfaction, the Board had a fundamental responsibility to the Cooperative and its members to actively participate in setting the strategic direction of the Cooperative, to establish clear policies and procedures to protect the members, to oversee the financial condition of PEC, and to challenge Management on its approach in managing the business affairs of the Cooperative.

The format and regular contents of the Board package provided to each Board member in advance of the regular monthly Board meetings does not appear to have changed in many years, despite the fact that the Cooperative has grown substantially. While the standard Board package appears to have included a significant amount of information, the majority of the performance metric information was operational in nature (i.e., monthly consumer statistics, safety/accidents, number of personnel, correspondence/mailings, man-hours, consumer accounts receivable, etc.). Monthly summary level financial statements were also provided, as were listings of purchase orders and checks written. However, aside from the debt-service coverage ratio, the Board packages appear to have provided little additional financial metrics, expense analysis, or evaluation of PEC financial results relative to a budget or in comparison to other cooperatives or industry participants, with the exception of prior period comparisons.

12. Deficiencies in Board Governance and Oversight

Many aspects of the Board's conduct that fell short of the best practices of ideal corporate governance during the period under investigation. Since the advent of the Sarbanes-Oxley Act in 2002 and subsequent corporate governance recommendations, corporate Boards have become subject to increasing scrutiny and to higher expectations than was the case during the early periods under investigation. The governance process employed by the Board did not significantly change during the period under investigation, even though the Cooperative nearly tripled in size during that period. The expectations of good corporate governance have clearly changed over the past decade, and the risks are significantly greater for a corporation that fails to employ policies and procedures designed to safeguard the entity's assets.

In summary, the Board exercised inadequate oversight over the Cooperative's former General Manager and Board President, as well as with respect to the overall strategic direction of the Cooperative. As a threshold matter, in our opinion the Board's tacit acceptance of related-party transactions of the magnitude observed with the Cooperative's former General Counsel (A.W. Moursund, and later the Moursund Law Firm) was flawed. In addition, the Board, by its inaction or passivity, appears to have relinquished to the former General Manager many of its responsibilities for establishing the strategic direction of the Cooperative and for safeguarding its assets.

The Board appears to have frequently deferred to Mr. Fuelberg, allowing him to run and control Board meetings, set the agendas, and determine who would contact the Board and what information would be provided to it. With limited and controlled information, combined with the relatively short duration of most meetings, the Board was unable to engage in substantive and effective debate. During Mr. Fuelberg's tenure, it appears that the Board answered to him rather than the General Manager answering to the Board. In essence, Mr. Fuelberg did not seek advice from the Board, only approval, and in most cases, he sought mere ratification of his actions.

While the Cooperative's successes during the period of investigation are noteworthy, the Board's apparent failure to fulfill certain of its responsibilities and willingness to allow the Cooperative's General Manager, as well as the Board President and outside General Counsel, to assume substantive control over the Cooperative put the Cooperative and its members at risk.

A fundamental control flaw for the PEC Board during the period under investigation might be characterized as the Board's failure to distinguish between its own role as the policy-making body, and the General Manager's role as the executive responsible for carrying out that policy. The apparent acquiescence by the Board in allowing the former General Manager to assume substantive control over the Cooperative significantly undermined the effectiveness of the Board.

D. Recommendations

Over the last few years, corporations of all types, including nonprofits, have come under greater scrutiny to demonstrate their public accountability. Even though not subject to the requirements of the Sarbanes-Oxley Act, nonprofit entities like PEC may avail themselves of many provisions that provide guidance as to best practices, including the adoption of written conflicts of interest, document retention, and whistleblower policies. Likewise, companies that utilize outside auditors are well-advised to establish an independent audit committee to oversee the performance and receipt of the audit.

Navigant Consulting suggests a number of governance-related recommendations to improve the effectiveness and oversight of PEC's Board. While certain of the recommendations are in response to the deficiencies outlined in this section of the Report, others address additional areas for improvement with respect to other issues evaluated during the course of our investigation that are described elsewhere in this Report. Navigant Consulting's observations and recommendations include the following:

Board Election Process

- Navigant Consulting acknowledges the present Board's efforts to amend the Cooperative's Bylaws and abolish the Board's use of a "nominating committee" in exchange for a more open and democratic Board election process. Under the circumstances, Navigant Consulting considers the Board's changes to be appropriate.

- The use of nominating committees in Board selection processes is not uncommon to ensure a Board balanced with the requisite skills and experience to assist the corporation in addressing its various challenges. Absent the use of such a process, Navigant Consulting recommends the Board evaluate the use of the appointed Advisory Director at-large positions to fulfill certain functional skill requirements (e.g., financial, corporate governance) that may not be accomplished through an open-election process

Level of Board Expertise

- While Navigant Consulting acknowledges that the Board plays an important substantive role, as well as a symbolic role in a member-owned/member-controlled cooperative, for an organization as complex as PEC with total assets surpassing $1 billion, PEC needs an active governing Board with Directors that can commit the necessary time and proper oversight to achieve the organization's goals.

- It is important for the Board to maintain and expand the level of expertise among its Directors on key issues, especially financial management and corporate governance.

- We recommend that the Cooperative and its members endeavor to include some individuals with financial literacy on its Board, in order to ensure the proper implementation of financial controls, as well as the effectiveness of the Board's Audit Committee and its fundamental responsibilities. Some progress has been made in this respect since PEC's 2008 Board election.

- To achieve these objectives, and in light of the new open election process, we recommend the Board consider using the Advisory Director at-large position, as described above, as well as 1) adopting minimum criteria for Board members, and 2) employing outside experts and consultants to advise the Board and its Committees in specific subject areas where it may be lacking the necessary expertise.

Financial Review

- One of the primary duties of the Board is to ensure that all financial matters of the Cooperative are conducted legally, ethically, and in accordance with proper accounting rules.

- We recommend that the Board receive and review timely reports of the Cooperative's financial activities, including the review and approval of the Cooperative's annual budgets and/or forecasts, and monitoring of actual performance against those forecasts.

Re-Design of Board Packages

- In conjunction with new management, it is recommended that the Board identify and adopt new financial performance metrics in evaluating the various strategic objectives of the Cooperative, including the importance of maintaining certain financial ratios (e.g., liquidity and equity).

- It is recommended that the financial metrics encompass the following: 1) the various financial ratios measured for conformance with PEC's financial commitments and mortgage debt covenants, 2) PEC's strategic objectives in managing patronage capital and the potential return of that capital through the payment of capital credits, 3) actual and forecasted capital expenditures, 4) forecasted capital needs, and 5) overall financial performance, including management of controllable expenses, in relation to other electric utilities and distribution cooperatives.

Review of Form 990 Disclosures

- It is recommended that the Board or an appropriate committee (e.g., the Audit Committee) review the Cooperative's annual Form 990 informational return each year for accuracy.

Travel and Expense Reimbursement

- It is recommended that the Board establish clear, written policies for paying or reimbursing expenses incurred by anyone conducting business or traveling on behalf of the organization.

- It is also recommended that the Board adopt clear guidance on the Cooperative's travel rules, including the types of expenses that can be reimbursed and the documentation required to receive reimbursement. Such a policy should require that travel on the Cooperative's behalf be undertaken in an efficient and cost-effective manner. The travel policy should be provided and adhered to by anyone traveling on behalf of the Cooperative, including Senior Management and the Board. In addition, the Board's policy should also state that it will not pay for nor reimburse travel expenditures for a spouse, dependents, or others who are accompanying an individual conducting business for the Cooperative unless the additional person is also conducting business for the Cooperative.

- Federal per diem rates, while not applicable to PEC, can be a useful guide. Any use of these rates in establishing PEC policy should take into account that there are many circumstances in which it is not possible or reasonable to reimburse at federal per diem rates while conducting business. Another factor of consideration in this regard is that federal government employees are eligible for travel services and are able to secure special rates for travel and accommodations that are not generally available to non-governmental organizations.

Appropriate Board Size

- The Board should review its Board size to determine the most appropriate size to ensure effective governance and to meet the Cooperative's goals.

Board Term Limits

- Many Boards of Directors, including those of cooperatives, have provisions limiting Directors to specified terms, e.g., two consecutive three-year terms with eligibility for re-election after a year off. It is recommended that PEC, at a minimum, evaluate the advantages and disadvantages for adopting a policy related to term limits.

Clarification of Board Roles and Fiduciary Responsibilities

- The role of the Board relative to Senior Management should be clarified. This assessment can be accomplished through a well-defined, and documented, delegation of authority outlining the respective responsibilities and associated authority delegated to Senior Management, as well as the authority reserved by the Board.[73]

- Additionally, maintaining a compilation of relevant Board resolutions with ease of access can prevent unwarranted dilution of the delegation of authority policy or confusion due to potentially conflicting Board resolutions.

- We recommend that the Board members, and especially new members, periodically receive training on their fiduciary responsibilities to the Cooperative. While the objective of impressing on Board members their fiduciary obligations generally can be accomplished through Board training; instituting a defined Code of Ethics and Board self-evaluation process could facilitate the Board's efforts.

Board Education and Training

- Boards are beginning to place increasing emphasis on continuing education and development to ensure that their members are up-to-date in their knowledge and skills. A knowledgeable, committed Board is one of the strongest protectors of a Board's ability to fulfill its oversight and decision-making functions.

- We recommend that the Board establish an effective, systematic process for educating and communicating with Board members to ensure that they are aware of their legal and ethical responsibilities, are knowledgeable about the programs and operations of the Cooperative, and can carry out their oversight functions effectively.

Conflict of Interest Policy

- An important step in preventing abuse in and protecting the reputation of the Cooperative is the identification and appropriate management of apparent and actual conflicts of interest, as well as suspected cases of malfeasance or misconduct.

- As a matter of recommended practice, the Board should adopt and enforce a conflict-of-interest policy consistent with the Cooperative's needs and the underlying laws of the State of Texas, as well as adopt and implement policies to ensure that all conflicts of interest, or the

[73] The Board Policy relating to Authority and Responsibilities adopted by the Pedernales Electric Cooperative, Inc. Board on November 17, 2008 largely achieves this objective. This policy should be re-examined at appropriate intervals to ensure that it optimally meets the Cooperative's goals.

appearance of any such conflicts, including relationships with potentially related parties, within the Cooperative and the Board are appropriately managed through proper disclosure and necessary actions in relation to voting on items before the Board.

- Board members should certify on a periodic basis that they have disclosed any relationships with related parties and that they are in compliance with the conflict of interest policy.

- The Board needs to establish a policy and procedures for certain members to be recused who may have a potential or perceived conflict of interest.

Code of Ethics and Code of Conduct

- It is recommended that the Board develop and adopt a formal written code of ethics with which all of its Directors are familiar and to which they adhere, as well as a formal code of conduct outlining the specific conduct anticipated in adherence to the code of ethics. The policy should be applicable to all Directors and require annual compliance certificates.

- It is recommended that a separate code of ethics and code of conduct be developed for all PEC employees, including requesting certification, as well as periodic renewal of such certifications.

Whistleblower Policy

- The Board should also adopt policies and procedures that encourage and protect individuals who come forward with credible information on illegal practices or violations of adopted policies of the organization, as well as efforts to address possible conflicts of interest and the reporting of suspected malfeasance and misconduct by the Cooperative's managers.

- This "whistleblower" policy should specify that the organization will not retaliate against, and will protect the confidentiality of, individuals who make good-faith reports.

Greater Transparency

- It is recommended that PEC adopt policies to promote openness and transparency for the benefit of the Cooperative's members. While PEC is not subject to the referenced Sarbanes-Oxley legislation and SEC disclosure requirements, those standards provide useful benchmarks for companies seeking to follow industry best practices.

- PEC could also demonstrate its commitment to transparency and accountability by offering additional information about the activities of the Board and management on the Cooperative's website.

General Manager Performance Evaluation and Compensation

- It is recommended that the Board evaluate the performance of the General Manager annually. The evaluation would then serve as the basis for any compensation adjustments. It is recommended that the Board develop a systematic approach to benchmarking executive compensation with a defined group of comparable organizations.

- We recommend that the Board establish a standing Compensation Committee tasked with the responsibility and the authority for overseeing the evaluation the General Manager's performance, as well as future modifications of the General Manager's overall compensation and the components of that compensation.

Board Effectiveness and Evaluation

- We recommend that the Board members evaluate their performance as a group and as individuals periodically, and adopt clear procedures for removing Board members who are unable or unwilling to fulfill their responsibilities.

VI. Operational Review and Evaluation

A. Background

An operational review and evaluation was undertaken at the request of current PEC management based on an appreciation of the organizational challenges facing the Cooperative and its objective to develop more efficient operations without jeopardizing the strong customer service focus of the Cooperative.

1. Industry/Market Trends and Challenges

While all electric utilities have a common requirement to secure power supply, and to transmit and distribute electricity, each operates differently to meet the unique needs of its customer mix and service area.

Shift from Corrective to Reliability-Centered Maintenance

In the late 1990's, cooperatives embarked on initiatives to reduce outages and outage times. These projects, still ongoing, include a substantial level of system rebuilding and a related strengthening of line maintenance programs. Spending on tree trimming, pole and equipment inspections, and replacement of old, undersized and inadequate equipment has increased significantly. Measures to improve power quality have been driven primarily by evolving customer service level expectations and the penetration of digital products in homes and businesses.

Increasing Need for Automation Technologies

Cooperatives, along with other electric distribution utilities, are under increasing pressure to improve efficiencies because of escalating operating costs. At the same time, it is becoming more difficult to attract and retain qualified personnel, including linemen. With the advantages of automation technologies emerging under new market conditions, many cooperatives are adopting distribution automation, broader use of their Supervisory Control And Data Acquisition ("SCADA") tools and Automated Metering Infrastructure ("AMI") technology, which can improve efficiencies in a number of areas. The accrued benefits result in shorter outage duration, improved power quality, and ultimately, improved customer service. The investments needed to modernize today's electric utility distribution systems (i.e., AMI, substation automation, SCADA) require funds that exceed historic investment levels.

2. PEC's Growth and Success

To better address the significant challenge of its high growth rate and increasing service quality expectations of its members, PEC has deployed a number of new and enhanced technologies. Decisions in recent years include:

- Expanding deployment of SCADA technology to better support routine operations and enhance outage restoration.

- Installing an improved outage management system that increases PEC's ability to handle large volume outages and better manage outage assessments.

- Installing AMI technology to increase efficiency in meter reading and become better positioned to offer an expanded range of rate and service offerings in the future

- Installing an enhanced billing software to more effectively address the large increase in billing requirements.

These new systems have been implemented without sacrificing system integrity or efficiency. Indeed, while member power rates appear to have been maintained at reasonable levels during the turbulent times of the 1990's and early 2000's, PEC continues to operate the electric system to meet the needs of its membership and support economic development in its rapidly growing service area. PEC's success with its membership stems from two primary areas of activity, discussed below.

Customer Care and Satisfaction

Throughout PEC's Annual Reports over the years, PEC has echoed its ongoing goals in servicing its members. Top among those goals has been to provide its members with unequaled customer service and access to reliable and affordable power. These goals are routinely reiterated in PEC's Annual Reports to its members:

> *"Since its beginning in 1938, the Cooperative has been committed to delivering reliable electricity, providing comprehensive customer service, and supporting the communities we serve. Each year membership grows, technology changes, and we make upgrades and investments that ensure we will deliver reliable service."*[74]

PEC has participated in the J.D. Power and Associates Electric Utility Residential Customer Satisfaction survey over the past several years. During the period 2005 – 2007, PEC's performance consistently ranked in the top five in overall *customer satisfaction* (out of over 70 utilities in the medium-size utilities industry group), as well as in the top ten in *power quality and reliability* and *communication*s. In each of the three years, PEC has ranked first in *customer service* among its peers.[75]

Community Involvement

PEC actively supports the communities in its service area through various donations, participation in community initiatives and outreach programs, as well as encouraging its employees to volunteer their time to support worthy causes of their choice.

[74] Pedernales Electric Cooperative, Inc., Annual Report 2004.

[75] J.D. Power and Associates, Electric Utility Residential Customer Satisfaction Studies: 2005, 2006 and 2007, *Overall Customer Satisfaction Index* and *Power Quality and Reliability*.

PEC distributes thousands of dollars each year to charities through its *United Charities* program. It donates to various nonprofit organizations throughout the Hill Country through its *Light the Way* program and supports high schools in its service area through its PEC Scholarship Fund. PEC also provides community assistance with grant writing, business retention, and community development projects; in 2007, PEC assisted local organizations in raising over $782,323 in grant funds.[76]

B. Work Performed

This Operational Review and Evaluation employed a variety of analyses and approaches, including; benchmarking operational metrics, interviewing all managers reporting to either the General Manager or Assistant General Manager, assessing the effectiveness of PEC's technology deployment, and evaluating the effectiveness of PEC's current management organization structure.

1. Key Ratio Trend Analysis

The Cooperative Finance Corporation ("CFC") annually collects operational and financial data from cooperatives that participate in their financial services and uses this information to create an annual Key Ratio Trend Analysis ("KRTA") Report. This Report is comprised of 145 different ratios that cover a wide range of metrics covering both financial (i.e., debt and equity, revenue and expense) and operational (i.e., outage and usage) performance.

The KRTA Report compares PEC's performance ratios and data to its peers nationally, within the state of Texas, and cooperatives of a similar size (cooperatives serving over 100,000 customers). Navigant Consulting performed a detailed review of these ratios and prepared trend graphs for the period 2002 – 2007 to gain an understanding of PEC's current financial and operating status within the industry.

2. Review of Operational Performance

We reviewed PEC's policies, procedures, investment decisions, and indicators of past operational performance. Through this review we gained an understanding of the Cooperative's priorities and strengths. These activities also helped us to identify areas for potential improvement.

3. Headquarters and District manager Interviews

Navigant Consulting conducted interviews of every manager reporting to either the General Manager or Assistant General Manager; a total of 22 managers within the organization. The purpose of these interviews was to gain an understanding of the roles and responsibilities of the managers, what tools they used to manage their respective areas of responsibility, interdepartmental communication and cooperation tools, their view of key issues facing the utility, and the opportunities for improvement that may exist in the organization.

[76] Pedernales Electric Cooperative, Inc. Annual Report 2007.

4. Technology Evaluation

As part of the interview process, Navigant Consulting analyzed diagrams of the various information management systems and descriptions of technologies in use by PEC to meet its members' needs. The purpose of this analysis was to determine the current state of technology deployment and to determine if there are opportunities to leverage further technology investment to reduce costs or improve member satisfaction.

5. Organizational Structure Analysis

As part of the interview and analysis process, we reviewed the organizational structure, roles and responsibilities, and management practices. The purpose of this review was to identify opportunities to improve the efficiency and effectiveness of the organization to respond to its members' needs.

C. Observations and Findings

1. Results of Key Trend Ratio Analysis

An in-depth analysis of the KTRA Reports is included as Appendix B. Our analysis with regard to the operational metrics contained in the KRTA Reports indicates that PEC has achieved above-average operational performance related to outage statistics. These results confirm the success of management's goal to improve operational reliability with the investment in system upgrades and focused maintenance on areas with repeated outage.[77]

2. Cooperative Focus – Service and Reliability

Based on interviews and a review of consumer testimonials, as well as other indicators, it is clear that PEC's focus has been on system reliability and customer service. Under the former General Manager's direction, District managers were instructed to focus on serving customers and maintaining system integrity. District managers were not held responsible for costs and expenses, as the Cooperative did not use budgets. Instead, the primary metric used by the former General Manager to measure success of the District managers was the cumulative average annual service outage, with a goal of no more than 60 minutes of service outages for PEC members. For an electric cooperative with rural service area, this is an aggressive target.

Responsibility is placed specifically on District managers for all customer service, operations, and construction activities within the District. They have significant authority and autonomy to accomplish their objectives. This practice encourages District managers to be accountable for the performance of the electrical system within their District and for the actions of their employees. Because of the uniqueness of each of the Districts, this practice allows the District managers to adopt

[77] The analysis of the KRTA report included in Appendix B is based on CFC data for "Independent Cooperatives" which includes approximately 200 distribution cooperatives. The information and tables throughout the report are based on CFC data for all (approximately 800) distribution cooperatives. Minor differences were noted between the two data sets that do not affect the results of our analysis.

customer service policies, construction approaches, and management styles that fit with the unique aspects of their service area and their members. However, even with this individual approach in each District, there are common themes and guiding principles that are followed by all of the Districts. Some of these are highlighted below.

Focus on Reliability

The first and primary responsibility of each District manager is to focus on system reliability for members. A number of tools is used to accomplish this:

- "Blink Reports" from the SCADA system are used to determine where the areas of greatest outage risk exist. The outage management system (described below) identifies the types of devices that cause outages and are most likely to contribute to future outages.
- Line inspection reports provided through a contracted service identify damaged poles, vegetation issues, etc.
- Over-sizing of overhead conductors has contributed to higher investment costs, but this allows the system to absorb additional demand without major reconstruction or upgrade activities.
- Use of outsourced contract crews for construction and maintenance programs allows critical work to be scheduled in a timely manner to address serious system problems.

While none of these individual practices is unique, the availability of the full range of these practices to the District manager allows for considerable, focused activity to enhance reliability.

Customer Service Policies and Practices

While there are general Cooperative-wide policies and practices for customer service, District managers retain a significant amount of flexibility in the tools and approaches they employ. This includes the authority to grant some exceptions to line extension policies, interpret credit and collection policies, and the handling of customer claims. The front office at each of the District offices and the remote business office locations within each District all report to and take direction from the District manager and the supporting technical staff. Because a significant number of PEC members pay in person, or come into PEC offices to do business, this flexibility gives PEC a small-town, local, member-owned look and feel.

Autonomy with Collaboration

Each District manager is fully responsible for meeting members' needs and was delegated the necessary authority to accomplish the desired results. Only certain key issues, such as adding personnel or outsourcing crews, required approval from headquarters. Additionally, most supplies can be procured at the District level through the use of a credit card, or by making purchases at local businesses. Construction materials are ordered under existing PEC supply contracts.

While the Districts operate with considerable autonomy, there is nevertheless a significant amount of collaboration between the District managers themselves, as well as with centralized Headquarters functions in Johnson City. For instance:

- The SCADA group supports the local dispatching groups at the District offices by monitoring the electric distribution system centrally and identifying outages and/or areas of outage for the District offices to investigate and repair.
- The Engineering group supports Districts with engineering services when complex issues are involved, or special business practices need to be applied.
- The Project Maintenance group coordinates transmission and substation upgrades and maintenance with the District superintendents, linemen and contracted construction crews.
- The Project Maintenance group facilitates a system-wide process for establishing standard materials and construction practices.
- The Project Maintenance group also facilitates the creation and maintenance of unit cost standards to be used with outside construction and maintenance contractors.
- The District managers have monthly meetings in which they discuss issues, collaborate on common problems and meet jointly with the Johnson City Headquarters groups.

This collaboration between Headquarters and the District managers allows many of PEC's practices to be customized to the varying needs of its Districts and encourages the development and dissemination of best practices.

3. Customer Service Performance

For the past four years, PEC has participated in the J. D. Power Customer Satisfaction Surveys to determine whether it is meeting the expectations of its members. For the first three years of participation, PEC was among the top rated mid-sized electric utilities in the country. Of 76 participants, PEC ranked 2nd overall among the mid-sized utilities and received the top marks in customer service and service reliability.[78]

The overall ranking in 2008 suffered from a significant drop in "image" and "credibility."[79] While PEC's customer service satisfaction rating is still positive, a number of rating categories have fallen. Of the 20 utilities in the South mid-size utility sector, PEC dropped from second to seventh in the

[78] J.D. Power and Associates, Electric Utility Residential Customer Satisfaction Studies: 2005, 2006 and 2007, *Overall Customer Satisfaction Index* and *Power Quality and Reliability*.

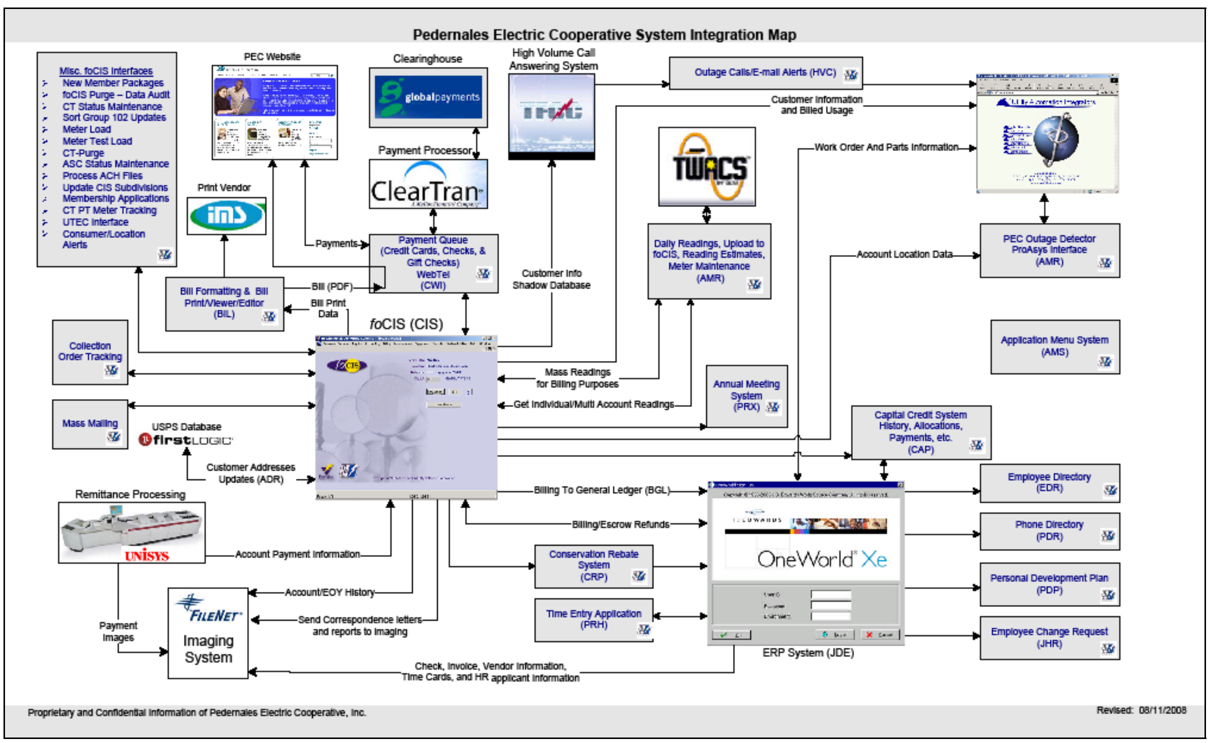
[79] J.D. Power and Associates, Electric Utility Residential Customer Satisfaction Studies: 2005, 2006 and 2007, *Overall Customer Satisfaction Index* and *Power Quality and Reliability*.

Overall Customer Satisfaction Index. However, an analysis of individual factors reveals that certain key service metrics actually improved during the 2004 to 2008 timeframe and remain overwhelmingly positive.

4. Technology as a Competitive Advantage

PEC has made a number of strategic investments in information technology over the past few years. Because of the vision of its management in recognizing the value of technology, and PEC's financial ability to make these investments, PEC has built a strategic advantage that will likely have long-lasting benefit to its members.

Provided below is an overview of the information systems architecture that is used to manage the utility. A few critical factors differentiate PEC's architecture from its peers; most significant is the use of TWACS® (*Two-Way Automated Communication System)* technology to communicate with devices at the members' premises. This proprietary system, licensed from Aclara, provides for timely billing, load control, demand response, and outage detection and assessment. Most utilities are in the early stages of implementing "the last mile" of communications with their customers, while PEC already has it.



Key technology systems that PEC uses and their functionality are as follows:

Supervisory Control and Data Acquisition ("SCADA")

This system provides remote communication with devices on the PEC electrical system and provides information about the system performance, and whether any issues exist. This system is used to collect historical information and to manage that data.

TWACS® (Two-Way Automated Communication System)

This system allows PEC to view devices on its electrical system, the most significant of which is the automated metering device at the member's premise. With this system, PEC is able to read its members' meters instantaneously, calculate consumption for billing, turn the service on and off, verify that service is active, and a myriad of other activities including distribution automation. Currently the technology is used primarily for automated meter reading. Significant opportunities exist for integration of this system with other billing and system operation functions.

Utility Automation Inc.'s ("UAI") Outage Management System

The outage management system interfaces with two specific applications to more accurately determine when and where an outage occurs, and to handle a large volume of trouble calls. The TWACS® PROASYS™ (Power Reliability Outage Assessment System) device outage interface is used to quickly assess system status and identify outages. When outages do occur, an Interactive Voice Response ("IVR") and high-volume call answering system is employed to take outage reports, collect and sort the data, and determine the most likely causes of outages very quickly. This system also supports automatic call-back to the members to confirm that service has been restored.

foCIS (fully optimized Customer Information System)

At the center of these systems is the Envision-developed billing and customer care software named foCIS. Integration between foCIS, the outage management system, the high-volume call answering system, and use of TWACS provides a number of advantages to the operations of PEC. These include the ability to change billing cycles, billing dates, establish payment programs, identify multiple outages, and track a history of customer service related issues back to individual customers and premises.

These systems provide a competitive advantage and enable PEC to monitor the condition of its electrical system, respond more quickly during outages or system problems, provide real-time billing and consumption information to members, and manage the overall resources of PEC. These investments are likely to pay significant future dividends as they provide a robust and scalable platform capable of evolving with the changing needs of the Cooperative.

5. Relationship between District Offices and Johnson City Headquarters Staff

A number of PEC Headquarters staff support the activities in the District Offices. However, it appears that these roles are not closely aligned with the needs of the District Offices. Examples include:

- An increasing number of projects that the District Offices face involve more complex planning than the District Offices can accommodate: housing developments, computer farms, highway relocations, large industrials, hotels and hospitals. These projects, designed at the District level, require engineering support from the central office. The current process appears inefficient.

- The centralized SCADA group supports the dispatchers during business hours, but currently the Districts maintain 24/7 coverage. Most Districts would like to have coverage for the non-business hours provided from SCADA in Johnson City and deploy call out lists for periods of problems.

- In the past, PEC generally took an individual approach to contracting for construction and tree trimming services. Monitoring and tracking the resulting myriad agreements was a complex and inefficient process. A unit pricing group has now been established and is charged with developing common contracts and common practices. Project Maintenance will maintain the contract specifications and be involved in developing contracts that are consistent.

- Based on interviews, there are some Districts in which the construction crews redesign projects and use materials other than those prescribed in the design. Best practices involve having standard construction specifications or compatible units that are used across the organization.

6. Operational Policies/Strategic Decisions – Limited Cost Analysis

It appears that PEC has made a number of significant capital investments over the years, apparently at the direction of the former General Manager, which may not have been fully evaluated from a cost/benefit perspective. These investment decisions may have had a detrimental effect on the membership, either through new cost pressures, or distractions from core business activities. Examples of past actions that appear to have lacked rigorous financial analysis include the following:

- Line Extension Policy: PEC made significant investments to increase system capacity. Many of these investment decisions appear to have been made without full due diligence. As a result, it is likely that some of the investments may not have been in the best interest of the overall membership of the Cooperative.

- Kimble District Acquisition: It appears that the Kimble Electric Cooperative was acquired with little or no prior analysis of the expected financial impact of the acquisition or the potential dilution of the existing membership's capital credits position. No due diligence has been identified establishing that the system was worth acquiring based on any objective criteria.

- Envision Acquisitions: No significant due diligence was performed to determine the financial impact of any of the three Envision acquisition transactions, nor was an estimate made of future costs or revenues.

D. Recommendations

Navigant Consulting has evaluated the current organizational structure of the Cooperative and the relationship between PEC Headquarters and the District Offices. A number of issues have been identified that appear to negatively impact the efficiency and effectiveness of PEC's operations. Based on Navigant Consulting's background and experience in utility operational reviews, a series of recommendations is offered to assist PEC improve its ability to efficiently provide its members with reliable and cost-competitive power.

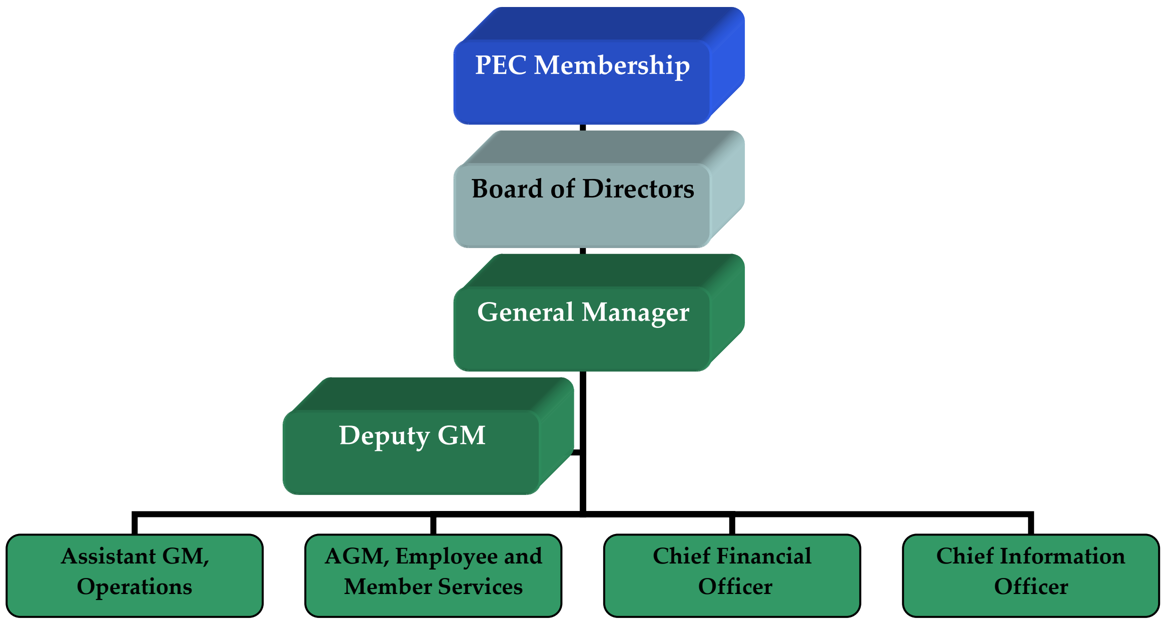
Perform Organizational Realignment

- It is recommended that PEC adopt an organizational structure that clearly delineates the roles and responsibilities of individual functional groups and the executive management to which they report. The top layer of that proposed organization is shown below.

- This proposed organizational structure provides for five key managers reporting to the General Manager:

  » Deputy General Manager
  » Assistant General Manager ("AGM") for Operations
  » Assistant General Manager for Employee and Member Services
  » Chief Financial Officer
  » Chief Information Officer

- The proposed structure is in addition to a General Manager staff support function, already in place, to address issues of governance, compliance, Board directives, and organizational development and culture.



- This structure focuses the Cooperative on its primary functions: transmission and distribution operations, employee and member services, financial and fiscal responsibility, and the importance of information technology investments in meeting members' needs.

- A major feature of this structure is the creation of a Deputy General Manager. This individual not only acts as a substitute for the General Manager, but drives many of the most strategic issues facing the Cooperative, including power supply, integrated resource planning, risk management, governance, compliance and regulatory and governmental affairs.

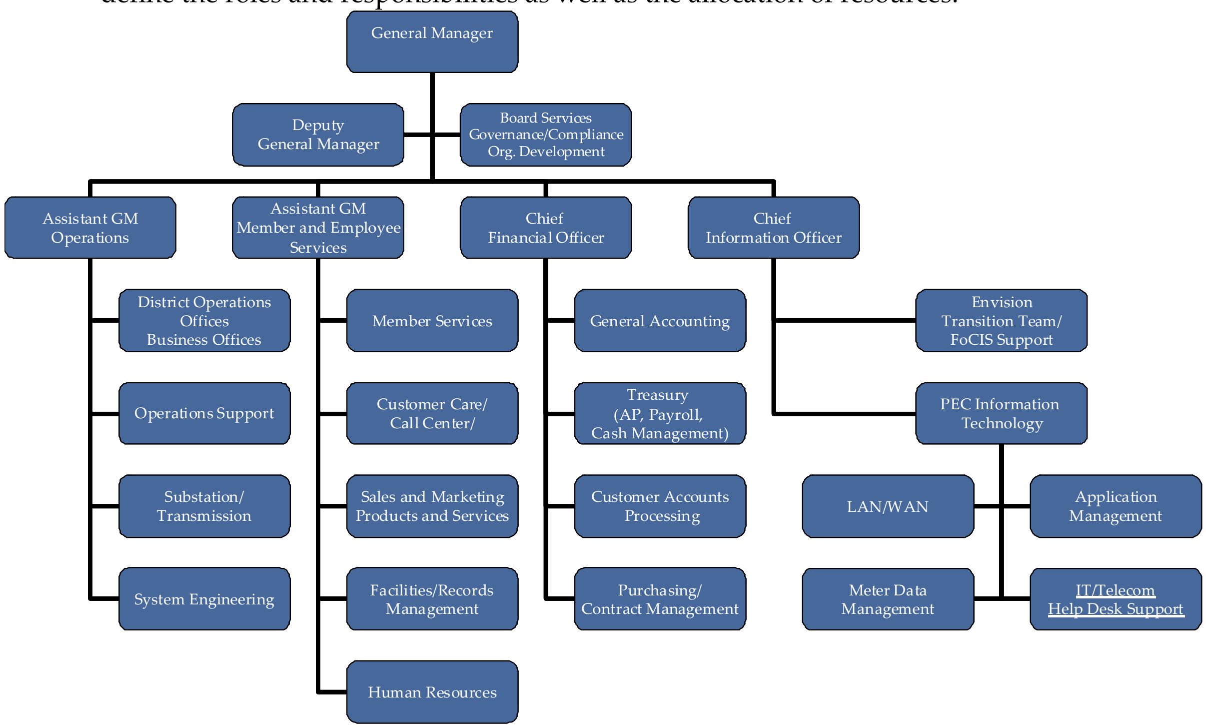
- As conceived, the Assistant General Manager ("AMG") for Operations has direct responsibility for the current District offices and a number of support functions in PEC's Johnson City headquarters. Project Maintenance, which maintains the substations, remains in this function, as well as Engineering and a new group referred to as Operations Support.

- The AGM for Employee and Member Services has primary responsibility for establishing the tone and message for managing relationships with members. Specific projects include communication programs, product and service offerings, community involvement, energy conservation, and renewable energy and sustainability programs. Additionally, this AGM has responsibility for facilities, administrative support, and human resources.

- Navigant Consulting supports PEC's decision, already implemented, to create the position of Chief Financial Officer. This individual, reporting directly to the General Manager, has responsibility for all financial functions including reporting, internal controls, cash management, financial planning and financing.

- The Chief Information Officer is a new position overseeing the computing infrastructure of the Cooperative and the functional areas within the organization responsible for deploying and managing technology. One of the most immediate tasks falling to this individual is the integration of the Envision software subsidiary into PEC's information system environment.

- Provided below is a detailed organization chart showing the recommended functional structure. We recommend that new senior management work with existing managers to define the roles and responsibilities as well as the allocation of resources.



Prepare a Long-Term (5 years or greater) Strategic Plan with Associated Long-Term Financial Plan

- It is recommended that senior management and the Board develop a Strategic Plan and Long-Term Financial Plan with input from members and PEC staff. These long-term plans will identify strategic objectives that can guide the investment decisions and operational activities of the organization. Key decision-making throughout the year will be based on impacts on the ongoing goals and objectives contained within the long-term plans. PEC should revisit, reassess, and reprioritize these directives annually.

Develop a Comprehensive Set of Formal Corporate Policies and Procedures for Each Functional Area

- PEC has not developed a comprehensive set of formal Corporate Policies and Procedures for each functional area. Some departments, such as Human Resources, have published certain components, but the framework is not complete. It is recommended that PEC management set goals and expectations, direct a process, and establish a defined schedule by which comprehensive policies and procedures are prepared and approved.

Establishment of Effective Metrics as Organizational Goals

- We recommend that PEC define a set of metrics that, in addition to customer service and network integrity, incorporate elements of cost and financial performance. Incorporating financial metrics into the evaluation process will ensure the operational decisions of the Cooperative contribute to its long term financial strength.

- It is recommended that as a first step in goal setting, PEC's management review the Key Ratio Trend Analysis (discussed in the Financial Review and Evaluation Section of this Report) and its own financial results to gain an understanding of PEC's comparative financial performance. As part of this process, we recommend that PEC identify its key cost drivers and adopt metrics and/or processes that can measure PEC's success in satisfying members' needs, while controlling costs. The metrics that should be considered include:

    » Average Operation and Maintenance ("O&M") cost per customer per District
    » Average O&M cost per mile of line per District
    » Average capital expenditure per customer per District
    » Average capital expenditure per mile of line per District
    » Revenue per kWh and per customer per District
    » Customer Average Interruption Duration Index ("CAIDI"): measures average length of time it takes to restore power after a system outage
    » Average Speed of Answer ("ASA"): measures average wait time before customer service calls are answered
    » Days Sales Outstanding ("DSO"): measures average number of days before payment is received for service provided

- Adopting relevant metrics across the organization and comparing them District by District can help to bring into focus those factors that contribute to the costs of meeting members' needs and highlight the initiatives that improve members' satisfaction levels.

Perform Member Service Staff Benchmarking

- It is recommended that PEC assess the organization and staffing levels of personnel for member services, including staffing at the Johnson City and San Marcos call centers, the front offices of each District and the remote business offices. Benchmarks are available that can be used as a guide to the appropriate staffing levels. We recommend that these staffing levels be evaluated in conjunction with the service levels that PEC has or will adopt as part of its performance metrics.

Adopt More Formalized and Consistent Materials Procurement Processes

- It is recommended that the purchasing responsibility be moved under the CFO and that this office monitors and controls the creation of purchase orders and the release of corresponding payments. We recommend that the Operations Group, meanwhile, maintain responsibility for creation of materials and construction standards, and the selection of the materials to be used and stocked in the warehouses. The CFO's role in the process, as conceived, is to facilitate the issuance of RFPs, RFIs and Invitations to Bid, establish purchase orders when a vendor has been selected, process releases against the purchase orders, and process payment to vendors once goods or services are verified as received.

Implement 24/7 Centralized Dispatching

- It is recommended that PEC establish a working group to evaluate the prospects for creating a centralized 24/7 dispatching function. While there is value to a District's knowledge of its service territory and the facilities in its District when responding to an outage, the necessity of maintaining dispatching personnel 24/7 at each of the District offices is questionable, and appears to be most effectively addressed from a central location. We recommend that call-out lists be established so that personnel in the Districts could be directed to assess and perform service restorations on the system.

Centralize Other Key Functions

- Navigant Consulting supports PEC's efforts to create a unit pricing group to develop common contracts, and believes this approach can be implemented across other functions as well. Best practices in the utility industry include some functions that are centralized to support District or field offices and personnel. By adopting common practices, designs, standards, and construction techniques, skilled technical staff can adequately be rotated to other Districts during periods of storm restoration, or can replace staff during absences and manager rotation practices.

- It is recommended that an operational support planning group be created to review PEC's current approach to designing, engineering, building, and managing the cooperatives' construction projects. We recommend that procedures be realigned to standardize best practices and make efficient use of resources.

Establish Requirements for PEC Information System and Telecommunication Infrastructure Investment

- It is recommended that PEC undertake a significant upgrade of its telecommunications network. Some remote sites experience system response times that are still at undesired levels and telecommunication connections are occasionally lost altogether. This is especially difficult for the remote offices using the foCIS billing system. There is a need for increased bandwidth for communications with these offices as well as with substations and devices.

- We recommend that PEC develop a strategic information technology plan. With the investments that have been made in foCIS, TWACS, UAI and other software applications, PEC is on the verge of being able to implement a system that is "smart" enough to monitor itself and predict and resolve potential problems. Such a system is known as an "intelligent grid." However, key aspects of the communications network will need significant investment, including completion of an enterprise-wide fiber optics backbone, a land mobile radio system, and upgrades to offices and substations for both bandwidth and redundancy. A strategic information technology plan provides a roadmap to gaining full benefit of today's and tomorrow's technology investment.

VII. Financial Review and Evaluation

A. Background

Many of the questions raised in the class action lawsuit, as well as by Cooperative members, the media and other interested parties, are either influenced by the financial performance and condition of the Cooperative (e.g., capital credits), or have a direct impact on this aspect of PEC (e.g., compensation, travel and other controllable expenses). During the course of the investigation, Navigant Consulting performed a high-level analysis of the financial performance and condition of the Cooperative relative to certain of the issues and questions identified throughout the Report. This effort focused on the performance of the Cooperative during the ten-year period under investigation and included an analysis of certain financial performance metrics in comparison to similar metrics at other electric cooperatives.

B. Work Performed

Among the work steps that Navigant Consulting performed are the following:

- Consolidating and analyzing PEC's historical financial statements, trial balances and general ledger reports for the period 1998 – 2007.

- Reviewing and evaluating certain controllable expense and other financial performance metrics included in the Key Ratio Trend Analysis ("KRTA") published by the Cooperative Finance Corporation ("CFC"), including areas where the Cooperative may be performing better than comparable electric cooperatives, as well as areas in which improvement may be needed.

- Interviewing various PEC employees, including the Cooperative's current CFO, regarding the general history of the Cooperative's financial and accounting policies, procedures and practices, as well as efforts to track and evaluate the Cooperative's financial performance over time.

- Reviewing reports issued by various bond rating agencies (i.e., Fitch Ratings, Standard & Poors, and Moody's) during the period under investigation, and with respect to the periods each was covering PEC issued bonds, including each agency's analysis and assessment of PEC's financial condition, as well as the relative financial performance ratios and other metrics observed by each.

- Performing a limited analysis of PEC's historical electric rates for residential customers in comparison to other regional providers of electric service.

C. Observations and Findings

1. Comparison of PEC's Electric Rates to Other Regional Utilities

A limited analysis of PEC's electric rates for its residential customers during the period 2003 – 2008 was conducted to provide additional perspective in relation to various issues and questions addressed in this Report. Electric service bill comparison data was obtained from publicly available information from the Public Utility Commission's website for four types of electric power suppliers including electric cooperatives, municipal electric utilities, and retail electric providers ("REPs") operating in the Oncor delivery service area, all of which are located within the Electric Reliability Council of Texas ("ERCOT") interconnected market; as well as several IOUs operating inside Texas but outside of ERCOT. A summary of the monthly pricing for residential customers using 1,000 kWh during the months of January and July for the period 2003 – 2008 is included in the table below.

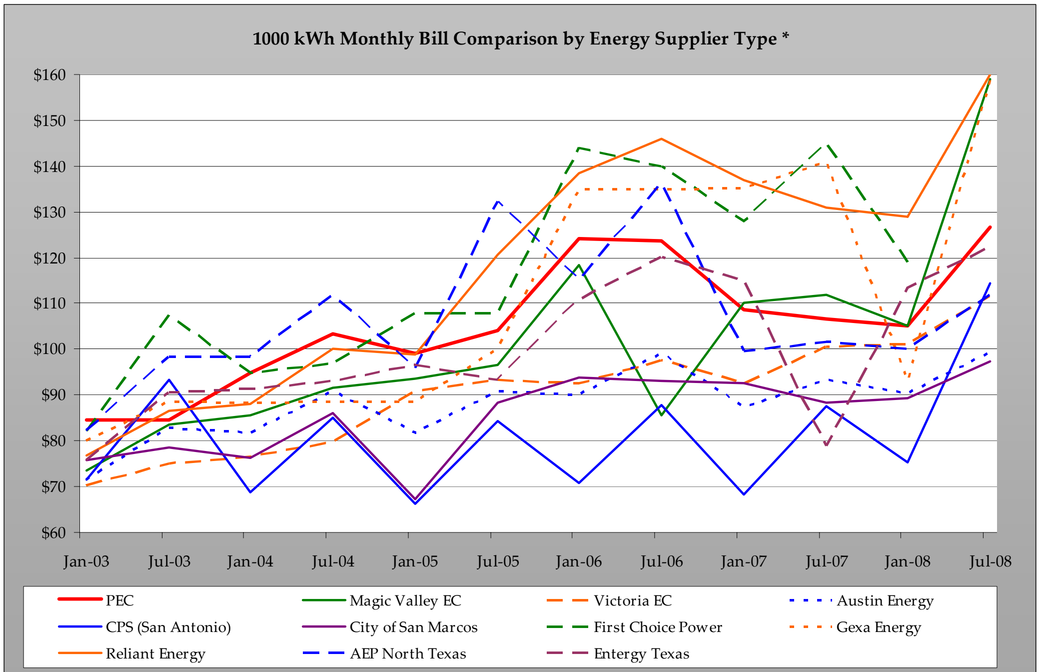
Pedernales Electric Cooperative, Inc. - Internal Investigation

Monthly Residential 1000 kWh Bill of PEC and Other Regional Utilities (2003-2008) *

	2003		2004		2005		2006		2007		2008	
	Jan.	July	Jan.	July	Jan.	July	Jan.	July	Jan.	July	Jan.	July
PEC	**$84.48**	**$84.48**	**$94.78**	**$103.28**	**$99.20**	**$104.20**	**$124.20**	**$123.70**	**$108.70**	**$106.70**	**$105.20**	**$126.78**
Cooperatives												
Blue Bonnet EC **	$73.40		$87.60									
Guadalupe Valley EC **	71.57	71.57	84.57	84.57								
Magic Valley EC	73.47	83.47	85.47	91.47	93.47	96.47	118.47	85.47	110.08	111.88	105.08	159.08
Victoria EC	70.21	75.14	76.44	79.74	90.95	93.31	92.50	97.54	92.50	100.59	101.20	111.55
Municipalities												
Austin Energy	$71.59	$82.89	$81.81	$90.81	$81.81	$90.81	$90.19	$99.19	$87.28	$93.29	$90.38	$99.38
CPS (San Antonio)	71.58	93.30	68.69	85.13	66.16	84.39	70.73	87.88	68.32	87.57	75.32	114.47
City of San Marcos	75.87	78.53	76.30	86.13	67.37	88.28	93.88	92.98	92.51	88.22	89.38	97.30
ERCOT Retail Electric Providers / Oncor Delivery												
First Choice Power	$81.95	$107.45	$94.95	$96.95	$107.95	$107.95	$143.95	$139.95	$127.95	$144.95	$118.95	$230.95
Gexa Energy	80.00	88.50	88.29	88.54	88.54	100.04	134.94	134.84	135.24	141.04	93.04	159.04
Reliant Energy	76.73	86.55	88.08	100.18	98.78	120.70	138.34	146.04	136.90	131.00	129.00	160.00
Investor Owned Utilities (Outside ERCOT)												
AEP North Texas	$82.41	$98.37	$98.25	$111.79	$95.75	$132.19	$115.03	$136.31	$99.67	$101.62	$100.18	$111.98
Entergy Texas	75.80	90.60	91.40	93.02	96.50	93.43	110.94	120.27	114.79	78.78	113.36	122.44

* Bill comparison data obtained from public records on PUC website.
** Limited bill comparison data filed at PUC.

Based on the limited comparison provided in the table above, PEC's historical residential power cost per 1,000 kWh is typically higher than the ERCOT cooperatives and ERCOT municipal electric utilities, lower than the ERCOT REPs, and comparable to the Texas IOUs operating outside of ERCOT. The graph below illustrates the differences in power pricing between the described entities during the period 2003 – 2008.



*The July 2008 figure of $230.95 for First Choice Power was excluded because the bill was an outlier.

2. Summary of PEC Operating Costs

The table below summarizes PEC's operating expenses during the period 1998 – 2007, including displaying the respective expenses as a percentage of PEC's operating revenues during each period.

Select Expenses as a % of Operating Revenue - December 31, 1998 to December 31, 2007 *

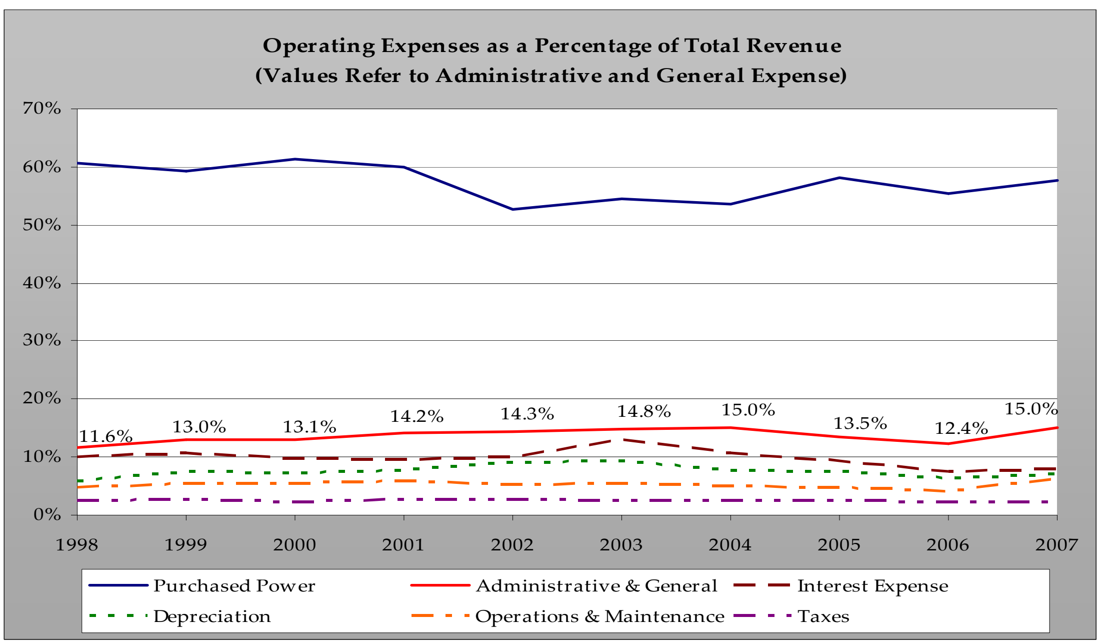
	12/31/98	12/31/99	12/31/00	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
Select Income Statement Figures										
Operating revenues	$182,421,206	$194,336,987	$240,982,608	$273,688,730	$278,417,095	$305,402,094	$366,237,716	$410,877,308	$495,996,272	$457,012,187
Operating Expenses:										
Purchased Power	$110,718,576	$115,174,827	$147,985,181	$164,108,094	$146,614,720	$166,538,011	$196,319,626	$239,294,861	$274,258,870	$263,545,140
Operations & Maintenance	8,890,951	10,580,427	13,193,704	16,375,618	14,838,779	16,480,213	18,489,221	19,344,115	20,823,007	29,516,286
Administrative & General	21,120,820	25,341,199	31,517,750	38,964,256	39,904,229	45,239,258	54,886,674	55,304,555	61,440,063	68,682,283
Depreciation	10,947,791	14,842,053	17,406,774	20,938,512	25,114,414	28,472,647	28,435,012	30,908,986	31,899,509	32,123,822
Property and Other Taxes	4,739,718	5,267,096	5,656,997	7,608,659	7,895,374	7,689,144	8,991,667	10,397,875	10,744,136	10,006,037
Total Operating Expenses	$156,417,856	$171,205,602	$215,760,406	$247,995,139	$234,367,516	$264,419,273	$307,122,200	$355,250,392	$399,165,585	$403,873,568
Total Interest Expense	$18,503,053	$20,796,661	$23,873,483	$26,116,141	$27,854,489	$39,932,017	$39,451,560	$38,409,353	$37,725,627	$36,682,504
Expenses as a % of Operating Revenue										
Operating Expenses:										
Purchased Power	60.7%	59.3%	61.4%	60.0%	52.7%	54.5%	53.6%	58.2%	55.3%	57.7%
Operations & Maintenance	4.9%	5.4%	5.5%	6.0%	5.3%	5.4%	5.0%	4.7%	4.2%	6.5%
Administrative and General	11.6%	13.0%	13.1%	14.2%	14.3%	14.8%	15.0%	13.5%	12.4%	15.0%
Depreciation	6.0%	7.6%	7.2%	7.7%	9.0%	9.3%	7.8%	7.5%	6.4%	7.0%
Property and Other Taxes	2.6%	2.7%	2.3%	2.8%	2.8%	2.5%	2.5%	2.5%	2.2%	2.2%
Total Operating Expenses	85.7%	88.1%	89.5%	90.6%	84.2%	86.6%	83.9%	86.5%	80.5%	88.4%
Total Interest Expense	10.1%	10.7%	9.9%	9.5%	10.0%	13.1%	10.8%	9.3%	7.6%	8.0%

* Source: 1998 - 2006 Audited and 2007 Unaudited Financial Statements

As evidenced by the table provided above, PEC's operating revenues increased by over 150% from approximately $182 million in 1998 to approximately $457 million in 2007, with operating revenues even higher in 2006 at almost $496 million. The largest component of PEC's operating expenses is the wholesale cost of power it purchases from LCRA for resale and distribution to its customers, which, on average, ranges from 55% - 60% of its overall operating costs. The cost of the power purchased by PEC is prescribed by the Cooperative's long-term wholesale power supply agreement with LCRA.

PEC's next largest expense item is "Administrative and General" expense, which in 2007 was approximately 15% of its operating revenues. However, while revenue increased by approximately 150% during the period under investigation, Administrative and General expenses increased by over 225%. While certain of the Cooperative's operating expenses in 2007 were influenced by the costs associated with the class action lawsuit, the general trends noted above indicate that Administrative and General expenses, as well as certain other controllable expenses, appear to have generally increased at a faster rate than the increase in operating revenues. In other words, while the Cooperative's operating revenues have increased significantly, certain of its controllable expenses (i.e., Administrative and General expenses) were increasing by even more. This trend is noted in the calculation of Administrative and General expenses as a percent of revenue, which has generally increased over the past ten years. Part of this increase in Administrative and General expenses appears to have been offset by a general decline in PEC's average cost of purchased power over the past five years, relative to the prior five years.

"Interest Expense" on PEC's sizable long-term debt is also a significant component of PEC's overall operating costs. The relationship of the various operating expenses as a percent of revenues is further depicted in the graph below:



As a company grows, its Administrative and General expenses, as a percentage of total revenue, are typically expected to decline. This is due to increased economies of scale and the ability to spread expenses over a larger base of operations. However, with notable exceptions in 2005 and 2006, PEC experienced exactly the opposite effect, suggesting that as the size of the organization increased, its efficiency decreased.

A review of PEC's income statement shows that PEC's Administrative and General expenses more than tripled from $21.1 million to $68.7 million during the period 1998 – 2007 with total expenses for the time period totaling over $442 million. A review of the KRTA (discussed in detail, below) reveals that compared to other large electric cooperatives during this time period, PEC consistently had the highest or second highest Administrative and General expenses per consumer.[80] Administrative and General expenses include compensation and expenses of PEC's Senior Management and Directors, as well as various other related expenses incurred in relation to the management of the Cooperative.

Examples of various PEC Administrative and General expenses are discussed throughout various sections of this Report.

3. Results of Key Trend Ratio Analysis ("KTRA")

PEC, as the country's largest electric cooperative, naturally has higher values in almost all financial categories than its peers. This large size makes comparisons at the aggregate level less meaningful. The CFC's KRTA Reports, described in an earlier section, provide a number of relative financial performance metrics that put this data into perspective. The KTRA Reports compare PEC's financial performance metrics to the median values of both: 1) other independent cooperatives in Texas, and 2) all cooperatives in the country that service more than 100,000 members (collectively referred to below as its "peer group"). Various financial performance metrics in relation to PEC's management of its controllable expenses relative to other electric cooperatives are discussed below:

Consumer Accounting Expense

PEC's consumer accounting expense per consumer ranks second, meaning 2nd from the highest, among its peers (i.e., the 20 largest cooperatives in the U.S.) and is approximately 55% higher than the average reported by its peers. In 2007, PEC spent approximately $28 per customer more than its peers and its cost per consumer has increased each year despite PEC's rapid growth.

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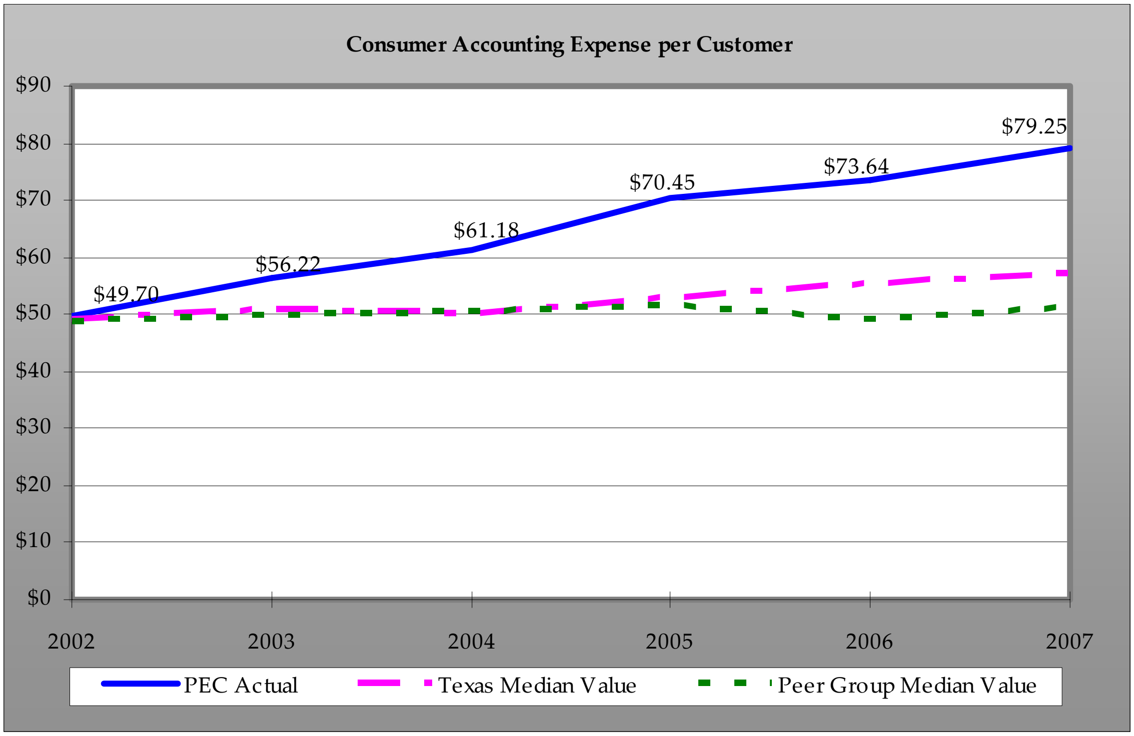
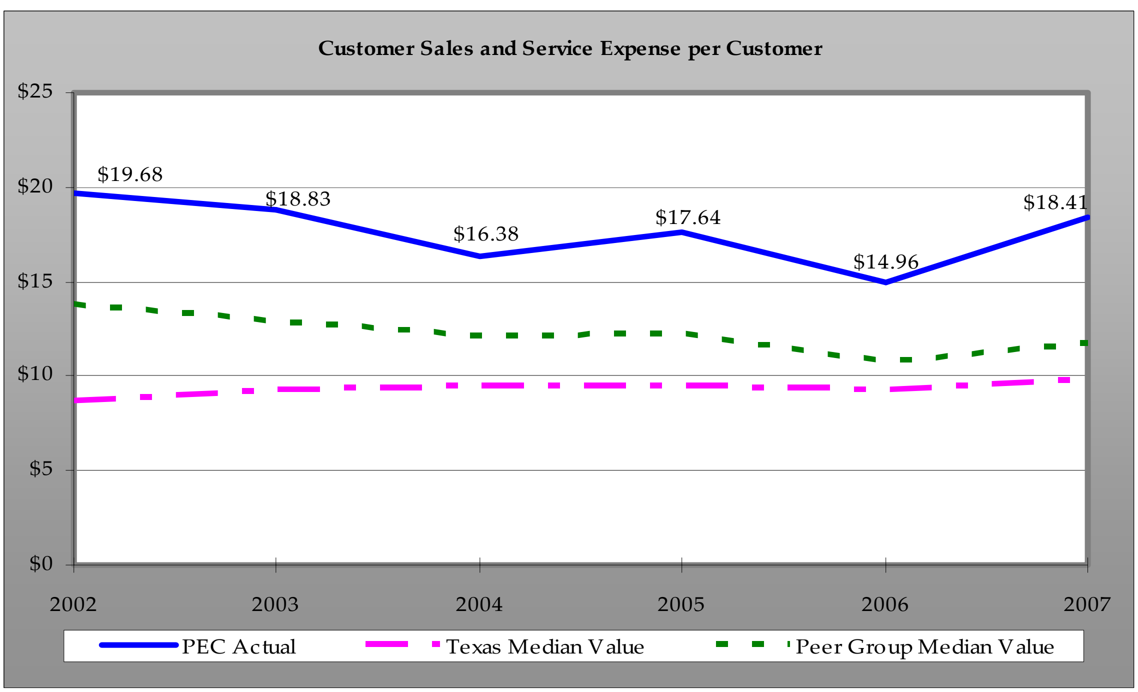
80 The financial statement information is based on Pedernales Electric Cooperative, Inc.'s audited financial statements for the periods listed. However, the KTRA Report does not include certain costs related to "Consumer Accounts," "Economic Development" and the Envision subsidiary in the Administrative and General total.

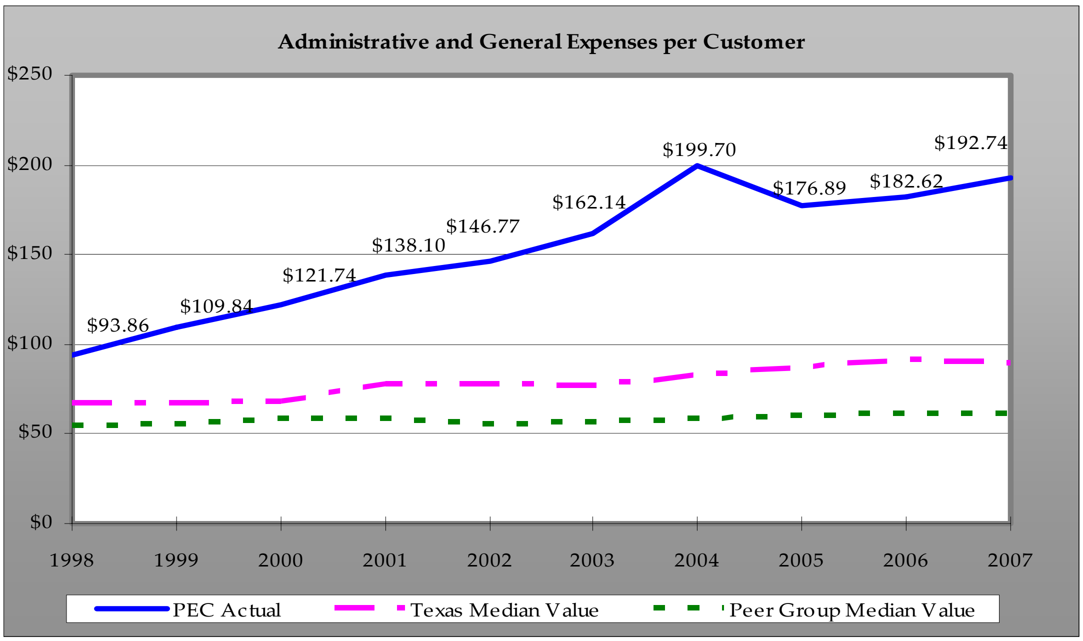


As shown in the graph below, PEC's customer sales and service costs, a component of Consumer Accounting expense, are approximately 57% higher per consumer than the average reported by its peers.

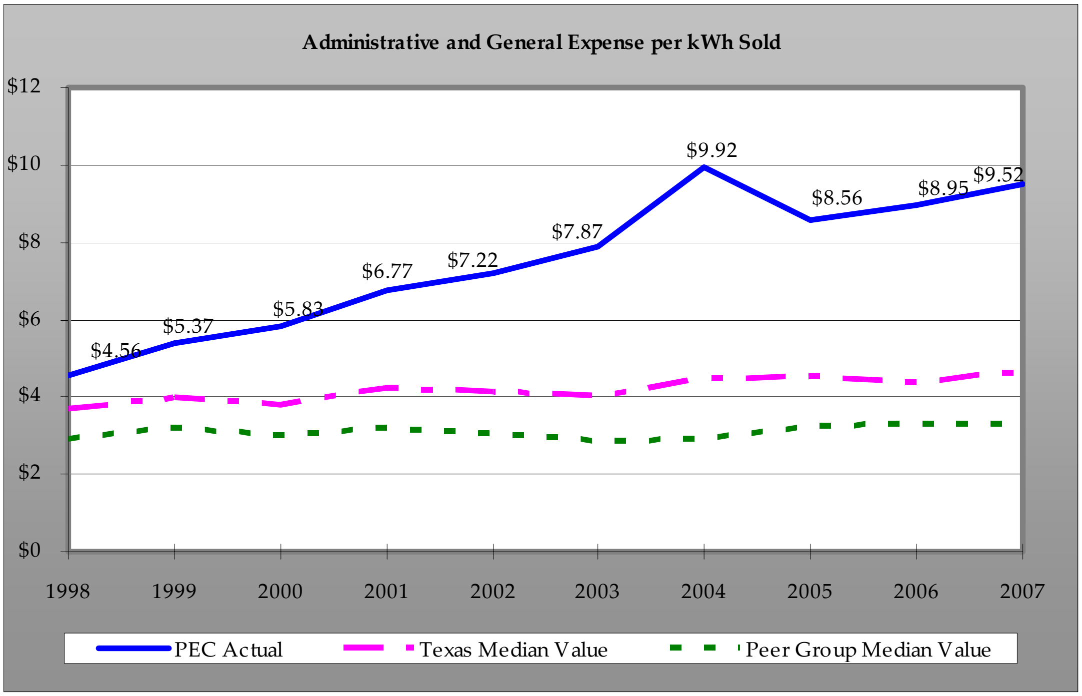


Administrative and General Expense

As described above, Administrative and General expenses per consumer represent a significant portion of PEC's controllable costs. The majority of these costs is attributable to employee wage and benefit expenses. The graph below shows that PEC's Administrative and General expenses are more than three times the average reported by its peers. Despite PEC's position as the largest electric cooperative in the country, PEC expends in excess of $130 per customer more than its peers for costs classified as Administrative and General.



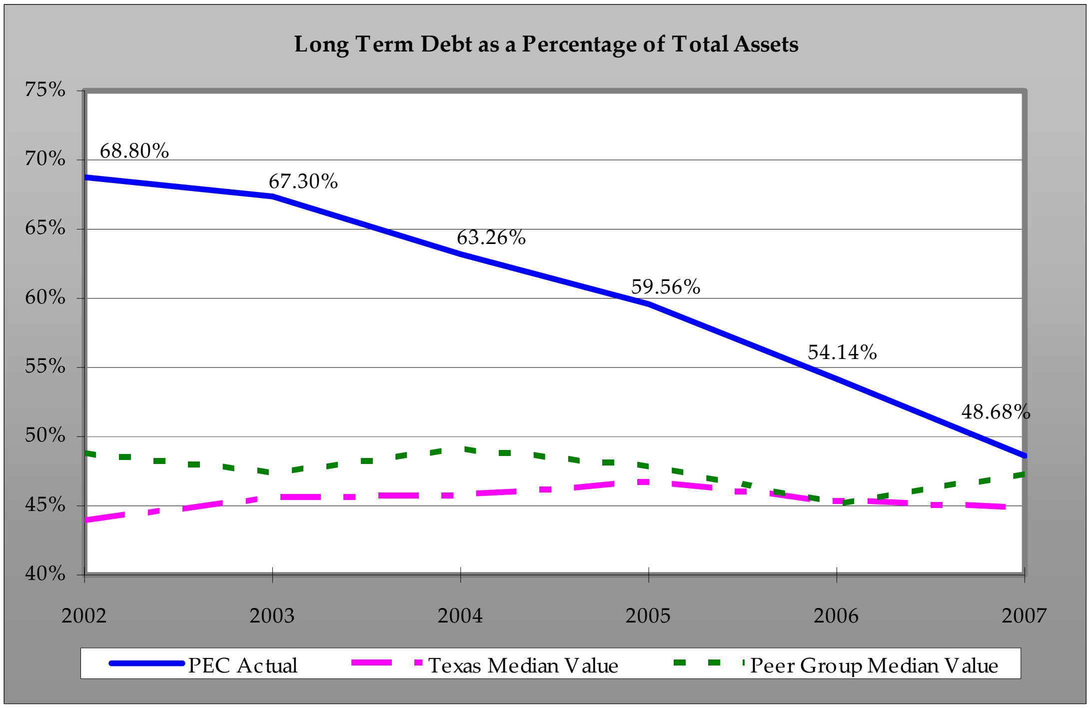
The KRTA Reports indicate that PEC's Administrative and General expenses are high relative to the quantity of power sold as well. In 2007, PEC incurred $9.52 per kWh sold in Administrative and General expenses, the highest among its peer group and nearly three times the $3.30 amount paid, on average, by other large cooperatives.



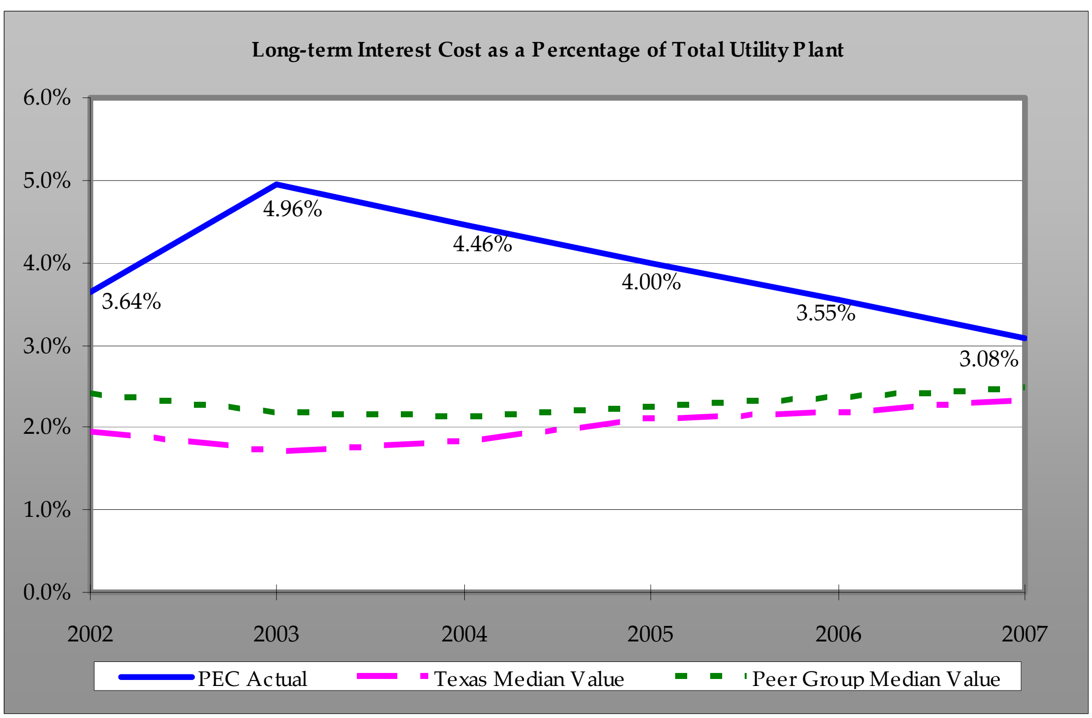
Interest Expense

PEC membership grew from 128,800 in 1998 to 221,276 at the end of 2007, equivalent to a sustained average growth rate in customers of over 6% per year over the ten year period. This increase in the number of consumers has forced PEC to invest over $750 million to build new or upgrade existing facilities to meet the energy demands of its new members. PEC has financed the largest proportion of this growth by borrowing, issuing approximately $445 million in new long-term debt through a combination of bonds and mortgage notes. Due to this borrowing activity, the Cooperative has experienced increases in expenses related to its required payments of interest and principal. In comparison to its peers, PEC has a much larger percentage of its infrastructure financed through borrowings. As a result, PEC's required debt repayment results in a higher percentage of overall energy costs being "fixed" in nature.

One of KRTA's metrics, comparing a cooperative's long-term debt to its total assets, indicates how much of a cooperative's facilities are funded by borrowing and how much it can be said to own outright. The graph below depicts that PEC's figure, as high as 68.80% in 2002, has been considerably above that of other cooperatives during the past five years. It is noteworthy, however, that PEC's percentage has since fallen, as it pays down its debt and builds additional assets, to below 50%. The most recent metric is approximately on par with the average for other large electric cooperatives.



Another metric, graphed below, relates interest expense to Total Utility Plant, and indicates that PEC's annual interest payments are comparatively larger than its peers, though the variance has declined in recent years.



4. Fiscal Controls and Financial Responsibility

In keeping with former Senior Management's focus on service rather than cost, PEC has few controls in place in relation to the Cooperative's overall investment decisions with regard to new utility plant. Decisions about what construction projects to undertake or how dollars are to be spent on capital projects do not go through a validation process to determine whether the cooperative can afford the project, and neither district-to-district nor project-to-project prioritization occurs. Construction activity is controlled by the number of construction crews available to a District manager.

In 2007, PEC spent $88 million in capital expenditures without submitting any of these projects to a prioritization process. District managers do not have cost estimates or budgets for their projects prior to beginning them. District managers do receive cost reports after the fact, but there are no reports that provide overall financial results for the district or information as to whether rates are adequate to cover costs.

In addition, a centralized purchasing system is not used to create purchase requisitions, manage releases of items against purchase orders, verify receipt of goods and services, or to issue payments to vendors. Much of this process is accomplished manually between Johnson City Headquarters staff and the Districts. While some central material supply agreements do exist, these agreements are not actually centrally managed. Instead, District warehouses order directly against them, rather than submit requisitions.

Additionally, there have been inconsistencies between districts regarding how specific contractors are placed under construction contracts, how their work is priced, and how disputes are handled. In addition, District Offices maintain their own bank accounts and reconcile their own bank statements.

D. Recommendations

Assess Level and Efficiency of Controllable Expenses

- It is recommended that PEC initiate a detailed review of its controllable expenses, particularly in respect to its Consumer Accounting and Administrative and General expenses and evaluate these costs against industry benchmarks to target areas for potential cost reduction. However, this activity must include an evaluation of how each of the identified cost components relates to PEC's strategic goals. For example, PEC may very well make a conscious decision to accept higher costs in certain areas based on an expected return in customer satisfaction.

Prepare a Long-Term (5 years or greater) Strategic Plan and Financial Plan

- It is recommended that management and the Board develop a Strategic Plan and Long-Range Financial Plan with input from members and PEC staff. These long-term plans will identify strategic objectives that can guide the investment decisions and operational activities of the organization. Key decision-making throughout the year will be based on impacts on the ongoing goals and objectives contained within the Strategic Plan. PEC should revisit, reassess, and reprioritize these directives annually.

Establish Capital Expenditure Planning and Prioritization Process

- We recommend that PEC adopt an annual process for determining the level of capital expenditures that will be necessary to meet its membership's needs. Although there is a relatively sophisticated financial model that PEC uses to forecast revenues, expenses and margins, this model is not used to plan or determine PEC's capital investments. Since this annual expenditure approaches $100 million per year, there should be a process for evaluating PEC's investment options against the goals of achieving desired reliability and service levels, maintaining acceptable financial conditions, and limiting increases in costs to members.

- It is recommended that PEC implement a process to prioritize projects after the annual capital budget level is identified. Such a process identifies the potential risks and advantages of the project and quantifies the expected costs and benefits. Implementing this approach forces rigorous analysis of prospective projects and reduces the likelihood of poor investment decisions. We recommend that PEC establish a working group to create this process, and to establish the criteria that will be used for prioritization of projects.

VIII. Power Cost Determination – Cost Recovery Factors ("PCRF")

A. Background

During the course of the investigation, questions were raised regarding past processes employed by PEC in determining and implementing changes to the electric rates charged to its customers. Questions were primarily focused around the years 2004 and 2006, years for which PEC recorded significant net margins (approximately $20.6 million and $62.0 million, respectively).

As described previously, PEC is organized pursuant to the Texas Electric Cooperative Act as a "Nonprofit Operation," which is defined as an organization that "shall operate without profit to its members."[81] However, cooperatives, like most other businesses, have certain capital needs for new property, plant, and equipment, as well as a need to maintain certain revenue reserves. These additional capital and reserve requirements are typically met through a cooperative's excess margins, i.e., the excess of its revenues over its operating expenses each year.

In managing an electric distribution cooperative to provide for required or needed capital, the principal components impacting net margins are the wholesale cost of power purchased for distribution to a cooperative's customers (typically the largest operating cost for a distribution utility), and the rates charged by a cooperative to its customers. The inquiry is thus whether the rate structure is sufficient to fully recover the wholesale cost of power, as well as all other costs of operation, and to provide for the required level of capital and reserves.

PEC purchases substantially all of its electric power for distribution to its customers from the Lower Colorado River Authority (LCRA). Throughout a given year, LCRA may raise or lower the rates it charges to its wholesale customers (e.g., PEC) several times as its costs of generation fluctuate. Consequently, the cost of power supplied by PEC to its customers may change several times in a given year.

Since the early to mid 1970's, it has been a common practice for electric utilities to be allowed by their regulators to impose an essentially automatic surcharge on customers' bills to allow the timely recovery of highly fluctuating fuel and purchased power costs. Pursuant to applicable rules of the Public Utility Commission of Texas ("Public Utility Commission"):[82]

> *An electric utility which purchases electricity at wholesale…may be allowed to include within its tariff a PCRF [Power Cost Recovery Factor] clause which authorizes the electric utility to charge or credit its customer for the cost of power and energy purchased to the extent that such costs vary from the purchased power cost utilized to fix the base rates of the electric utility.*

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[81] Electric Cooperative Corporation Act, Tex. Util. Code Ann. § 161.059, et seq. (Vernon 1997).

[82] Public Utility Commission of Texas, Chapter 25. Substantive Rules Applicable to Electric Service Providers, §25.238 Power Cost Recovery Factors.

In other words, electric utilities were given the authority to include an adjustment factor in the monthly electric bills to their customers to enable the utilities to adjust their rates due to fluctuating wholesale power costs, without the need for a regulatory adjustment of their entire rate structure. Essentially, the PCRF is designed to allow an electric utility to recover the difference between the current cost of power and the (typically lower) cost of power as structured in its base rates.[83] PEC defines its Power Cost Recovery Factor as the "Annual Estimated Cost per kilowatt-hour ("kWh") not recovered in Base Rates."[84]

Prior to the deregulation of electric cooperatives in Texas, the PCRF charge was authorized and administered pursuant to the rules of the Public Utility Commission. After 1999, rate regulation of cooperative electric utilities was eliminated as part of the transition to a deregulated retail electric market in Texas. The rates charged by PEC were henceforth determined by the PEC Board. PEC's Bylaws specifically prescribe that "Any change in rates, Business Rules, or Tariffs charged by the Cooperative must be approved by the Board of Directors."[85] The Cooperative's Business Rules and Tariffs are listed in a separate document that details the various guidelines and procedures followed by PEC in establishing and changing its rates.

PEC reviews its rates and fees annually for recovery of costs. Recommended changes to the base rates, as necessitated by changes in operating, maintenance, and capital costs, are reviewed and approved by the Board as needed. Additional changes to the PCRF are made in the rates to account for changes in purchased power throughout the year.[86] PEC essentially endeavors to set its electric rates at a level sufficient to recover its operating costs, as well as meet its debt service and debt service coverage requirements.

Rate setting is an activity that would have been formally conducted by the PEC Board, as the entity vested by statute with that authority. It is our understanding that a policy may have been in place requiring the Board to consider rates at least once annually.[87]

For the latter part of the investigation period, and particularly for 2004 and 2006, the focus of questions raised was essentially whether the PCRF was inappropriately manipulated by PEC in order to affect the level of PEC's revenues or margins.

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[83] Tariff for Electric Service Provided by Pedernales Electric Cooperative, Inc., adopted October 17, 2005.

[84] Pedernales Electric Cooperative, Inc.'s power cost adjustment process works more specifically as follows: Within Pedernales Electric Cooperative, Inc. customers' standard rates, as with other electric utilities, a set level of fuel and purchased power costs is embedded in the current base rate. In addition, a calculated surcharge or credit per kWh (i.e., PCRF) equivalent to the cost of power above or below the embedded power cost is added to the customer's bill on a per kWh consumption basis. As the forecasted fuel and purchased power costs fluctuate, primarily through rate adjustments from LCRA, Pedernales Electric Cooperative, Inc. historically would use a financial forecast model to estimate the impact on Pedernales Electric Cooperative, Inc.'s net margins, as well as certain financial ratios used to manage the business and the expectations from the rating agencies responsible for evaluating the risk associated with Pedernales Electric Cooperative, Inc.'s corporate bonds.

[85] Bylaws of Pedernales Electric Cooperative, Inc., revised as of January 31, 2008.

[86] Pedernales Electric Cooperative, Inc. Annual Report 2006.

[87] Pedernales Electric Cooperative, Inc. Press Release, January 28, 2000.

B. Work Performed

Navigant Consulting performed a number of work steps to gain an understanding of the history behind the development and implementation of the PCRF, including the periodic processes and methodologies followed by PEC in adjusting the PCRF, as well as an evaluation of whether any issues or concerns exist with the adjustments made during the 1998 – 2007 time period. Among the work steps that Navigant Consulting performed are the following:

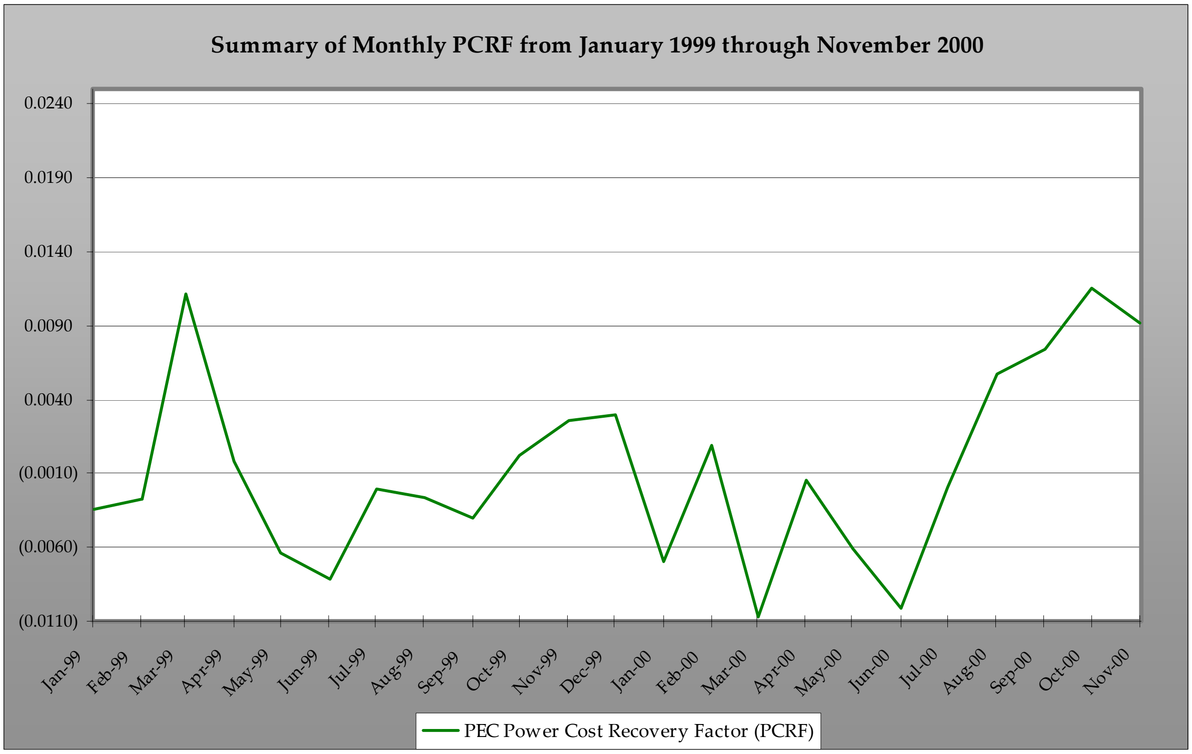
- Researching Board minutes and supporting documentation to create a history of the PCRF implementation and ensuing changes in the rate.
- Summarizing changes that were made in the PCRF since October 2000, including comparing to changes in the wholesale cost of power from LCRA.
- Reviewing the processes used for evaluating potential changes in the PCRF, including identifying individuals responsible for preparing the financial forecast models and making recommendations in relation to PCRF adjustments.
- Analyzing detailed financial forecast models used as a basis for adjustments in the PCRF, including determining the impact of changes in power costs and kWh sales on revenues, expenses and net margins.
- Interviewing PEC personnel involved in the periodic PCRF review process, including those involved in the development and maintenance of the identified financial forecast models.
- Reviewing statements published by PEC either to its members or in its Annual Reports explaining any rate changes.
- Reviewing bond rating agency comments concerning PEC's financial condition, and where applicable, the role of the PCRF utilized by PEC.

C. Observations and Findings

1. PCRF prior to 2000

For the entirety of 1999, and through October 2000, PEC changed its PCRF every month, resulting in significant fluctuations in the rates charged to PEC customers. Provided below is a graph of the adjustments that occurred for each of those months.[88]

[88] Pedernales Electric Cooperative, Inc., Residential Rates 1998 – 2007.



Because PEC was still regulated by the Public Utility Commission in 1998 and a portion of 1999, we did not focus significant attention on PEC's rate changes and its use of the PCRF during this period.

2. Change to PCRF Process in 2000

In January 2000, PEC announced to its members changes in a number of business aspects of its operations, including changes in the manner in which the PCRF would be applied.[89] Citing concerns regarding monthly fluctuations in the PCRF and the resulting fluctuating bills each month for PEC's customers, PEC announced that it would be changing its method of applying its PCRF from a monthly to an annual basis. PEC cited that the new annual PCRF process would be based on LCRA's projected costs for wholesale power.

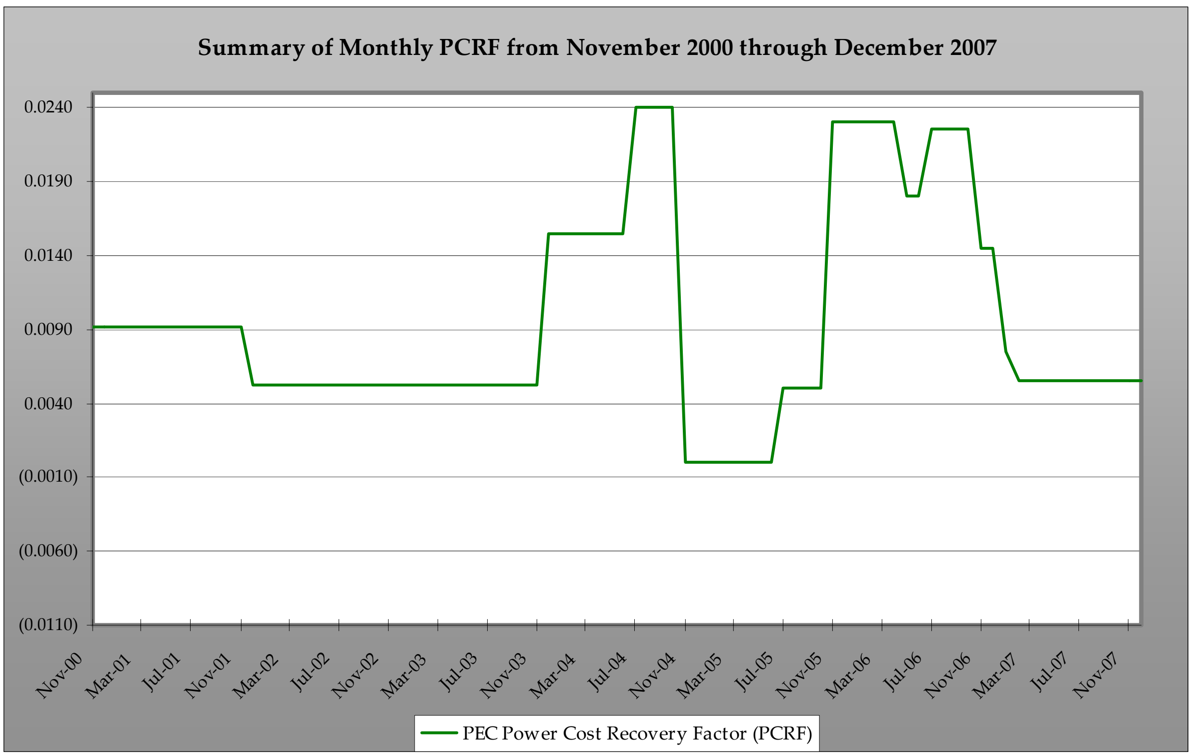
The new PCRF practice became effective later that year when the Board approved the Cooperative's PCRF of $.0092 per kWh sold, effective as of November 1, 2000.[90] Beginning at that time, the PCRF was calculated using the previous 12 months' power costs per kWh to develop an average cost per kWh to be applied to sales for the following year, or until such time as LCRA initiated a change in the purchased power charges made to PEC. Utilizing this approach, no changes were made in the PCRF

[89] Pedernales Electric Cooperative, Inc. New Services & Tariffs Open House, presented by Pedernales Electric Cooperative, Inc.

[90] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 23, 2000.

from that point until November 2001, when a decrease was granted from $.0092 to $.0052 per kWh sold, reportedly reflective of a decrease in LCRA's rates in October of that year.[91]

PEC held the PCRF constant for the next 24 months until December 2003, when it was effectively tripled from $.0052 per kWh sold to $.01550 per kWh sold.[92] PEC continued using primarily an annual basis for evaluating and adjusting its PCRF until 2004, when it changed to a semi-annual basis. Beginning in 2006, PEC began adjusting its PCRF on a more frequent "as-warranted" basis. The graph below shows the PCRF amount charged per kWh sold by month from November 2000 through December 2007.[93]



3. Pressures from the Rating Agencies

During the period 2001 through 2004, PEC was under pressure from the various rating agencies, whose rankings of debt for the investment community affected the cost of PEC's financings. Fitch, Moody's and S&P all raised concerns about PEC's lack of liquidity, high debt load, and its low debt-service coverage ratio. In 2002, Moody's changed its outlook on PEC's bonds from "stable" to "negative" citing PEC's high debt level. In 2003, Fitch noted PEC's low debt-service coverage ratio at 1.35 times (x). In 2004, S&P while noting improved liquidity at PEC, adjusted its rating to "negative" from "stable" as a result of concerns with PEC's debt-service coverage.

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[91] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., November 19, 2001.

[92] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 20, 2003.

[93] Pedernales Electric Cooperative, Inc., Residential Rates 1998 – 2007.

During this time, PEC became increasingly concerned with monitoring its margins and was under pressure from the rating agencies to increase its margins and its availability of cash. To quote Fitch, one aspect of this evaluation was how PEC was addressing purchased power costs: "While debt service coverage for 2003 was a low 1.35 times (x), the recent shift to a more timely purchase power adjustment clause will benefit PEC's debt-coverage ratios, which are expected to remain in the range of 1.75X—1.98X over the next several years."

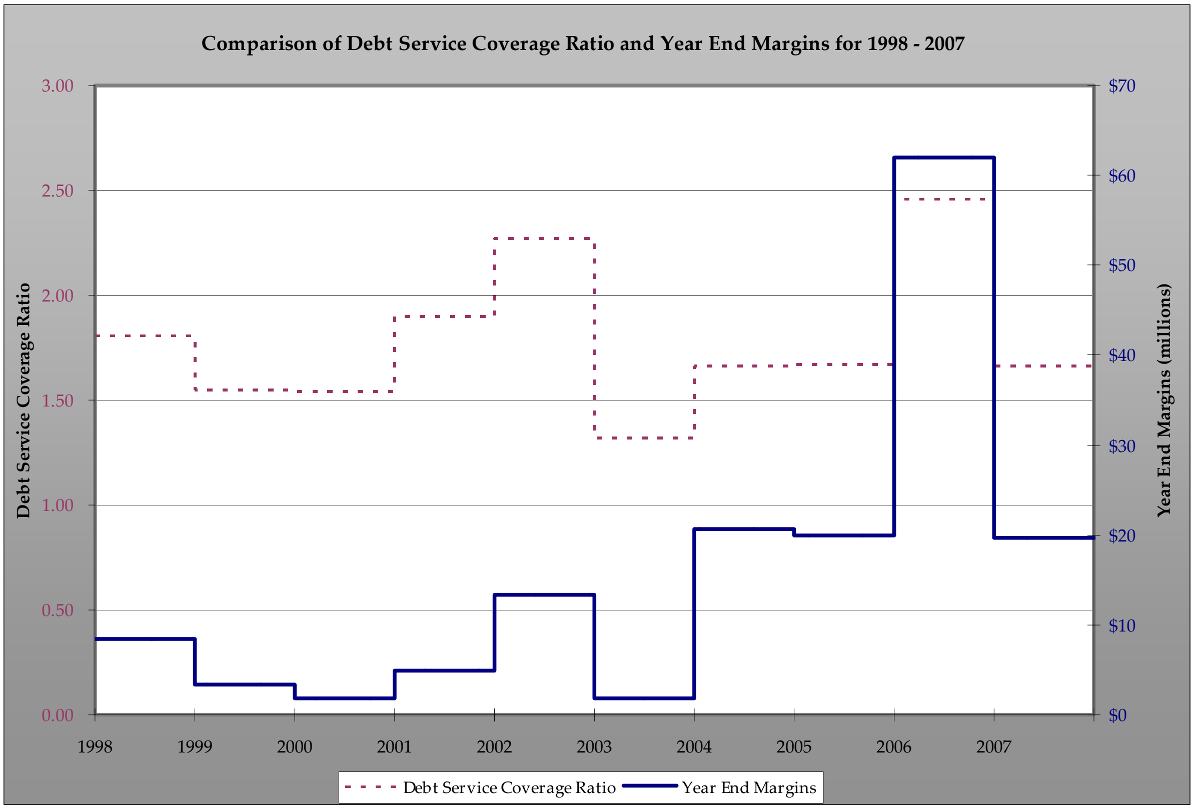
Principal metrics monitored by rating agencies include financial ratios related to a utility's ability to meet its debt obligations (i.e., debt service coverage ratio and times interest earned ratio), among others. Provided below is a table of PEC's margins, debt service coverage ratio ("DSC"), and times-interest-earned ratio ("TIER") by year from 1998 - 2007.

Year	Year End Margin	DSC	TIER
1998	$8,451, 394	1.81	1.53
1999	3,422,007	1.55	1.24
2000	1,869,847	1.54	1.19
2001	4,923,425	1.90	1.40
2002	13,284,158	2.27	1.48
2003	1,846,723	1.32	1.05
2004	20,654,524	1.66	1.51
2005	19,922,996	1.67	1.50
2006	61,967,089	2.46	2.60
2007	19,667,142	1.66	1.52

As can be seen in the table above, substantial fluctuations occurred in these financial measures over the years, including periods in which the financial measures went from one extreme to another. In citing reasons for its downgrade of PEC's bond rating to "negative" from "stable" in early 2004, S&P was critical of PEC's "power cost pass-through mechanism" and of the fact that PEC was not consistently adjusting its PCRF to "ensure full and timely recovery of wholesale power costs in retail rates."[94] S&P concluded that PEC's failure to increase rates in May 2003, following an LCRA rate increase, was "solely responsible" for PEC's low DSC ratio, and downgraded its bond outlook from "stable" to "negative."

The rating agencies were concerned that PEC needed to establish appropriate cash reserves and more appropriately manage its margins in order to maintain its debt service coverage in a financially prudent range, including demonstrating a willingness to raise rates sufficiently to maintain PEC's DSC and TIER ratios. The graph below displays the relationship between margins and the DSC ratio.

[94] Standard & Poors, Outlook on Pedernales Electric Coop, TX's Bonds Revised to Negative; 'AA-' Rating affirmed April 9, 2004.



4. PEC's Model for Forecasting PCRF Adequacy and Adjustments

In the wake of these concerns raised by the ratings agencies, and of S&P's downgrade of the outlook for PEC's bonds, PEC agreed to evaluate and make rate adjustments more proactively. As part of the process for monitoring the adequacy of PEC's rates and the PCRF adjustment factor, PEC personnel developed a sophisticated financial model to forecast PEC's annual revenues, costs (including purchased power), margins, and financial ratios. This model was updated each month for actual performance from prior months, as well as for any known or identified changes for the remaining months in the forecast period. The target established by the model was to provide for a debt service coverage ratio of 1.7 times, the level that had been represented to the bond rating agencies over time as PEC's objective.

PEC's forecast model included various elements that could impact PEC's costs and revenues, including known changes in LCRA rates per kWh, changes in consumption due to weather or other causes, and any significant and/or unusual changes in forecasted costs. In essence, PEC's model was used not only to support changes in the PCRF through changes in the cost of purchased power, but also to monitor and evaluate various other measures that impact total power costs, including kWh sales and changes in other forecasted costs, as well as the impact on PEC's margins and its benchmark debt service coverage and times-interest-earned ratios. In reality, PEC's process was focused on managing its margins and financial ratios (i.e., a margin adjustment factor) rather than the

PCRF itself; the PCRF was merely a mechanism for adjusting revenue inflow to optimize margins and the related ratios.

5. Process for Submitting PCRF Change Recommendations to the Board

PEC has historically used a "Rates Committee" that has the function of reviewing the results of the monthly financial forecast model. The Rates Committee was typically made up of the Finance Manager, Distribution Engineering Manager, Account Services Manager, and sometimes the Operations Manager. If it perceived a need to make an adjustment to the PCRF, the Rates Committee prepared a recommendation memo to the former General Manager, Mr. Fuelberg. Historically, this process was iterative in that the former General Manager would respond by having the Committee address specific questions or perhaps ask for another iteration or set of scenarios from the financial forecast model based on different assumptions.

The final determination of whether an adjustment would be made to the PCRF, including the amount of the adjustment, would be made by Mr. Fuelberg, who would then present the recommendation to the Board for approval.

6. Analysis of Reasons for Historical Adjustments to the PCRF

Based on a review of the frequency and purpose of the adjustments to the PCRF at PEC, it appears that PEC had reasonable justification for the vast majority of the changes that were instituted. Annual adjustments were made in December 2001 and December 2003, following PEC's new procedure announced in 2000 in making only annual adjustments. These adjustments were supported by analyses that support the changes. In 2004 and 2005, PEC began making semi-annual adjustments, consistent with its pledge to the bond rating agencies to be more proactive in adjusting its rates.

The 2004 and 2005 PCRF adjustments followed respective increases and decreases in PEC's wholesale power costs from LCRA. The PCRF changes in 2004 were authorized by the PEC Board only for the months of June, July, August and September (the LCRA rate increase was for three months (June, July and August).[95] Again in 2005, PEC adjusted its PCRF for the months of July through October in response to increases in its wholesale power costs from LCRA during the summer months.[96] Toward year-end in 2005, PEC's forecast model indicated that its margins were going to be significantly low at year-end, and as a result PEC's debt service coverage ratio would fall significantly below the 1.7 times ratio set as a target by the Cooperative. In addition, natural gas costs increased significantly during 2005, providing another factor compelling the need to evaluate a potential increase in the PCRF. An additional increase was made in October 2005.

A summary of the various adjustments made by PEC to its PCRF during the period 1998 – 2007 is provided in the table below:

[95] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 17, 2004.
[96] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 18, 2005.

Summary of PCRF Rates for 1998 - 2007 — Increase of the PCRF — Decrease of the PCRF

Year	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1998	(0.0065)	0.0000	0.0005	0.0002	(0.0042)	(0.0075)	(0.0040)	(0.0033)	(0.0019)	0.0013	(0.0038)	(0.0005)
1999	(0.0034)	(0.0027)	0.0112	(0.0002)	(0.0064)	(0.0082)	(0.0021)	(0.0026)	(0.0040)	0.0002	0.0026	0.0030
2000	(0.0069)	0.0009	(0.0107)	(0.0015)	(0.0061)	(0.0101)	(0.0020)	0.0057	0.0074	0.0115	0.0092	0.0092
2001	0.0092	0.0092	0.0092	0.0092	0.0092	0.0092	0.0092	0.0092	0.0092	0.0092	0.0092	0.0052
2002	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052
2003	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0052	0.0155
2004	0.0155	0.0155	0.0155	0.0155	0.0155	0.0155	0.0240	0.0240	0.0240	0.0240	0.0000	0.0000
2005	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0050	0.0050	0.0050	0.0050	0.0230	0.0230
2006	0.0230	0.0230	0.0230	0.0230	0.0180	0.0180	0.0225	0.0225	0.0225	0.0225	0.0145	0.0145
2007	0.0075	0.0055	0.0055	0.0055	0.0055	0.0055	0.0055	0.0055	0.0055	0.0055	0.0055	0.0055

PEC's revenue situation reversed in the following year, as a result of a number of factors. At 2006 year-end and again in January and February of 2007, PEC made significant reductions in the PCRF, in part because of significant margins ($62 million) earned in 2006.

7. Allegations Concerning PCRF Adjustments in 2006

Prior to and during the investigation, certain allegations were made that PEC had been using its PCRF adjustment factor (primarily in 2006) to build excessive margins to the detriment of the Cooperative's members. Three adjustments were made to the PCRF in 2006 including:

- April 17, 2006 – Effective in May, a pass-through of an LCRA decrease of $.005 per kWh sold (Board resolution incorrectly identifies this as an increase).[97]
- May 15, 2006 – Effective in June, July, August and September, an increase to pass through an LCRA increase of $.0045 per kWh sold.[98]
- September 18, 2006 – Effective in October, a decrease of $.008 per kWh sold.[99]

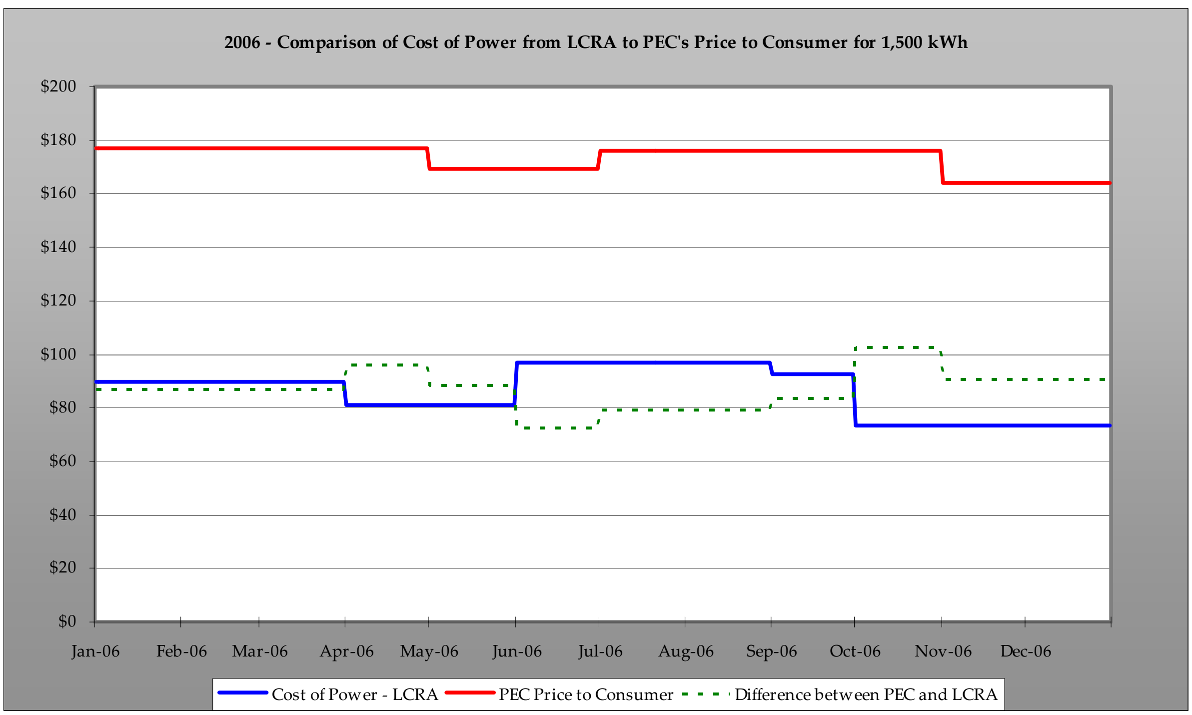
Primarily as a result of the increase in PEC's PCRF at the end of 2005, in early 2006 PEC was already forecasting that the Cooperative would end the year with significant margins. However, in March 2006 LCRA proposed reducing the price it charged its wholesale customers by up to 9%, following significant declines in the price of natural gas (which was one reason for PEC's increase in its PCRF at the end of 2005).[100] PEC estimated that a decrease of $.006 per kWh sold in its PCRF would match the LCRA price decrease.[101] Even with a $.006 decrease in PEC's PCRF beginning in April, PEC's Finance Manager estimated that PEC would end the year with in excess of $30 million in net margins and a

[97] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 17, 2006.
[98] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 15, 2006.
[99] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 17, 2006.
[100] Press Release, "LCRA Board of Directors Votes to Reduce Electric Rates by $60 Million," March 27, 2006.
[101] Pedernales Electric Cooperative, Inc. Internal Memorandum from Michael E. Vollmer to Bennie Fuelberg, Subject: Proposed Change in LCRA's Energy Factor, March 22, 2006.

debt service coverage ratio in excess of 2.0 (significantly above PEC's 1.7 benchmark).[102] The Board authorized a reduction in the PCRF in April by $.005 versus $.006 as referenced above.

In May, even with the reduction in the PCRF approved in April, PEC was forecasting a year-end net margin approaching $40 million and a debt service coverage ratio of 2.25, significantly higher than any net margin ever realized by PEC and a debt service coverage ratio significantly in excess of its target.[103] These values resulted primarily from actual and forecasted increases in the sale of electricity.

As in 2004 and 2005, LCRA increased its rates during the summer months in 2006. Because of the significant forecasted margins even if PEC kept its rates constant through year-end, the Rates Committee recommended that no corresponding increase be made in PEC's rates during the summer months.[104] However, this recommendation was overridden by the former General Manager, who presented a recommended rate increase to the Board of $.0045 kWh in May 2006, which the Board approved.[105] A graph displaying the relative increases and decreases in rates by PEC and LCRA, as well as the relative difference, is provided below:



[102] Pedernales Electric Cooperative, Inc., Project Year End 2006 Unconsolidated Statement of Revenues and Expenses January – February Actuals.

[103] Pedernales Electric Cooperative, Inc., Project Year End 2006 Unconsolidated Statement of Revenues and Expenses January – March Actuals.

[104] Memorandum from Dale Jones, Robert Peterson and Mike Vollmer to Bennie Fuelberg, Re: PCRF, May 10, 2006.

[105] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 15, 2006.

By August, PEC's financial forecast models were projecting that PEC would end the year with a net margin in excess of $50 million and a debt service coverage ratio of almost 2.5 times.[106] PEC began evaluating a decrease of its PCRF in September. A subsequent reduction in the PCRF of $.008 per kWh sold was approved by the Board in September, which became effective in November.[107] Even with the significant decrease in November, PEC ended the year with over $60 million in net margins and a debt service coverage ratio in excess of 2.46.

Before PEC's September-approved adjustment took effect, LCRA lowered its rate again for three months from September 25 to December 24, 2006.[108] In part due to LCRA's adjustment at year-end 2006, as well as PEC's significant margins at year-end, PEC adjusted its rates again in January and February 2007. The first decrease in the PCRF was approved by the Board in December 2006, to be effective January 1, 2007.[109] A subsequent adjustment was made in January 2007 to be effective January 25, 2007.[110] The PCRF adjustments in November, December and January brought the PEC financial forecast models back in line with their desired margins and debt service coverage ratio for 2007.

8. Evaluation of 2006 PCRF Adjustments

The case can be made that the PCRF adjustments in question were reasonably correlated to changes in LCRA's rates. A review of memos and "buckslips" in the PEC files for each of the rate changes evidence that various discussions occurred between the former General Manager and the Rates Committee, with a number of differences noted between their respective viewpoints. Whatever the differences of opinion, the ultimate determination of adjustments to PEC's PCRF was made by the former General Manager, Mr. Fuelberg.

Relative to the May 15, 2006 adjustment, a memo dated May 10, 2006 from the Distribution Engineering and Account Services Managers to Mr. Fuelberg states:

> *"When the Board approved 2.3 cents/kWh as the PCRF in October 2005, it was based upon our embedded cost of power of 4.889 cents and took into account the LCRA's proposed energy factor of 1.64 cents per kWh. It was at a minimum, for the period November 2005 through December 2006 and thus took into account the 1.08 cents/kWh increase in the LCRA's rates during the summer…..This set our PCRF at 1.8 cents/kWh which still includes the effect of the LCRA's 1.08 cents/kWh summer increase and which is forecasted to generate sufficient margins."*

This memo, essentially arguing in favor of not increasing the PCRF, is supported by documentation offering a number of financial scenarios that provide for a reduction in the PCRF through the

[106] Pedernales Electric Cooperative, Inc., Project Year End 2006 Unconsolidated Statement of Revenues and Expenses January – July Actuals.
[107] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., September 18, 2006.
[108] Letter from Marcus W. Pridgeon to Bennie Fuelberg, October 20, 2006.
[109] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 11, 2006.
[110] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., January 22, 2007.

summer, rather than an increase, which still resulted in a debt service coverage ratio of no less that 2.0, well above PEC's 1.7 target.

Shortly thereafter, a memo from the Finance Manager was sent to Mr. Fuelberg dated May 15, 2006 which provided an analysis of what the PCRF shortfall was projected to be for the ***four summer months only***, given certain assumptions (including a 6% increase in consumption). The Finance Manager presented a range of PCRF adjustments (i.e., increases) that would be required to cover just those four months of purchased power costs under each scenario. Apparently this ended up being the basis of the recommendation made to the Board by the former General Manager, despite the fact that all analyses indicated that there were margins sufficient to generate a debt service coverage ratio in excess of 2 times and far in excess of the target of 1.7 times, without any change to the PCRF.

The May 10th memo notwithstanding, Mr. Fuelberg recommended and the Board approved a $.0045 increase, which was one of the options included in the May 15, 2006 memo from the Finance Manager. Based on the interview comments of staff involved in this process, the former General Manager made the final decision as to whether a change needed to be taken to the Board and when it would be taken. In addition, staff members (such as those on the Rates Committee) were not allowed to participate in those discussions directly with the Board, and do not know what was ultimately presented to the Board or how it was presented. In this instance, it appears that when the former General Manager did not receive a recommendation that seemed appropriate to him, he went back to another source with a question different from the first and used the second response as a basis for his recommendations to the Board. In addition, based on our discussions with certain personnel, as well as our review of hard-copy files maintained in relation to each PCRF, it often appears that when the former General Manager did not agree with the first recommendation made by the Rates Committee, he would request additional work including changing various assumptions. We did not locate any documentation or analyses provided to the Board to support the change in the PCRF.

9. Authority of the Former General Manager Regarding PCRF

A review of the Board policies, Bylaws, and delegated authority actions taken by the Board disclosed no policies or guidelines for rate changes, including the PCRF. The only formal reference to rates is in the Bylaws, which state that all rate changes must be approved by the Board.

D. Recommendations

Establish a Definitive Policy Regarding Rate Changes

- PEC has recently contracted for an in-depth cost-of-service study from an outside independent rate consultant. Navigant Consulting considers the cost-of-service study to be appropriate. Based on this study, there may be changes to PEC's rate structure, including the PCRF. Such changes could include adjustments in the amount of cost included in the base rate to provide for flatter monthly bills, or conversely power costs could potentially be totally unbundled (broken out separately) to clarify PEC's cost structures to its members and provide improved price signals.

- It is recommended that during this process, the underlying objectives that will drive any change in rates, whether base rates or PCRF charges, be documented, including the financial metrics by which PEC is being measured by bond rating agencies and the debt covenants of its outstanding mortgage-based loans. The factors relating to these objectives might include, but are not limited to:

  - Frequency of rate adjustments
  - Adequacy of current rate offerings and structures
  - Appropriate ranges of financial indicators within which no changes will be made
  - Approaches to addressing volatility of rate changes (rate smoothing)

- It is recommended that the management and the Board formulate the guiding principles that best serve the entire membership, and from this discussion, develop and adopt appropriate policies.

IX. Accounting Treatment of Contributed Facilities (Capital)

A. Background

As part of the investigative process, PEC accounting, administrative and other staff were asked if there had been any transactions over the past ten years that raised questions in their minds, or otherwise caused concern as to the transaction's appropriateness. Among those issues identified by the PEC staff was the accounting treatment of underground and other distribution facilities ("distribution plant") that was built by developers and contributed to PEC to be owned and maintained over the life of the property. In 1997, PEC enacted a new approach to accounting for distribution plant obtained in this way. The new method, still in use today, impacts certain key operating and financial metrics.

1. Description of the Transaction

Under PEC's rules of service, there is a requirement that if a cooperative member wants underground service, as opposed to the standard overhead service, the member is required to pay the Cooperative for the difference in the costs of construction. This is supported through the signing of an underground agreement. A similar rule applies to developers who sign an underground agreement and request service for their real estate development projects from PEC. Following PEC's construction standards, developers dig, lay conduit, pull conductor, and prepare the ground for electric service within their subdivision or construction projects. PEC inspects the construction and if appropriately constructed, PEC pulls the wires and makes all electrical connections for the facilities. PEC then takes ownership of the underground facilities and is responsible for operations, replacement and maintenance of those facilities for the life of the assets.

2. PEC Accounting Treatment

From an accounting perspective, prior to 1997, PEC offset the cost of construction with the amount of payment received from the member, or in the case of developers, did not record the assets in the continuing property records or plant accounting system. If it was recorded, it was recorded at zero cost. However, in 1997, with the transition to KPMG as its new auditor, PEC changed its accounting policy and treatment to reflect the cost of the constructed assets as part of PEC's distribution plant, with a credit to members' equity for contributed capital. Footnote 9 from the notes to the 1997 Audited Financial Statements states:[111]

> *The Cooperative recorded a $32,551,432 net prior period adjustment to membership equity as previously reported at December 31, 1996 to capitalize underground electrical distribution systems as contributed facilities. Included in the determination of this amount was the underground conduit, underground conductors and secondary services. These assets are constructed by third parties and then donated to the Cooperative upon completion.*

[111] Pedernales Electric Cooperative, Inc., Audited Financial Statements 1997.

Through this transaction, PEC's Membership Equity account at December 31, 1996 was adjusted via a separate line item from $82,544,052 to $115,095,484. As part of the prior period adjustment, PEC's total utility plant, an asset account, was also increased by $43,757,338 for the contributed facilities. Accumulated Depreciation on those facilities was also credited for $11,205,906. Going forward, this larger total utility plant asset account served as the basis for depreciation expenses (which increased proportionally), and the amount for contributed capital plant was amortized as an offset to depreciation expense.

At the end of 2007, cumulative contributed capital totaled $192,510,414 of PEC's *Total Utility Plant in Service* of $1,219,635,205 (roughly 15.8%). Net of depreciation, the dollar value of contributed plant is $151,273,110 or 15% of net plant. The net effect on 2007 expenses is zero since the contributed capital value is being amortized as an offset to depreciation expense.

The primary concern is that of the $347,342,568 listed in total membership equity at December 31 2007, approximately 43% is made up of contributed capital for plant in service donated through the various transactions as described. In other words, while PEC lists almost $350 million in member equity, only $196 million actually came from the members through patronage capital from Cooperative annual net margins. The table below provides a break-out of PEC's *Total Utility Plant in Service* and member *Membership Equity* for the period 1998 - 2007.

Summary of Total Utility Plant in Service and Membership Equity for 1998 - 2007 (In Thousands)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Utility Plant in Service:										
Distribution Plant	$372,634	$416,971	$485,046	$546,553	$615,713	$676,352	$753,573	$824,323	$919,931	$1,026,738
General Plant	41,971	46,508	55,401	62,422	69,670	73,583	77,598	87,475	92,217	100,212
Transmission Plant	33,363	34,457	36,062	37,496	42,902	47,922	51,815	56,334	57,242	65,588
Construction WIP	13,935	12,108	17,641	25,161	16,212	11,366	7,811	8,260	11,154	27,098
Total Utility Plant in Service	**$461,904**	**$510,043**	**$594,150**	**$671,633**	**$744,496**	**$809,222**	**$890,797**	**$976,391**	**$1,080,543**	**$1,219,635**
Membership equity:										
Patronage Capital	$93,472	$96,894	$103,761	$108,684	$121,968	$123,815	$144,469	$164,392	$226,360	$215,681
Contributed Facilities	40,251	47,915	54,881	67,645	86,336	97,479	111,183	117,196	133,513	151,273
Membership Certificates	4,468	4,861	6,160	7,414	8,584	9,649	10,588	10,561	10,822	11,438
Accum. Comprehensive Income	-	-	-	-	-	-	-	-	-	(31,050)
Total Membership Equity	**$138,191**	**$149,670**	**$164,801**	**$183,743**	**$216,888**	**$230,943**	**$266,241**	**$292,150**	**$370,694**	**$347,343**

Accordingly, this accounting treatment has the effect of increasing assets and membership equity by the value of the contributed facilities. Of concern is the relative impact on various financial metrics and ratios utilized by bond rating agencies, debt lenders and even PEC in evaluating the financial condition of the company both individually and in relation or comparison to the industry and other electric cooperatives. By the value included in equity, it could lead an uninformed reader to misinterpret the true nature of PEC's capital structure, and its ability to pay out capital credits.

3. Alternative Accounting Treatment

The expressed concerns and questions surrounding PEC's accounting treatment stem both from a concern that the primary basis of the change in accounting treatment was to make plant investment look larger so that PEC could "be a billion dollar company," as well as the fact that PEC essentially created an equity value on the books for PEC, which was not represented by any outlay of capital on behalf of PEC. In addition, it appears that PEC is relatively unique among cooperatives in treating contributed facilities in this manner, although the accounting treatment has been supported by PEC's external auditor for a number of years. In addition, there also appears to be some dispute among various accounting staff as to which accounting treatment is more appropriate, although both appear to be acceptable standards at present. However, in reviewing the basis for the treatment, it would appear that there is some justification for the treatment PEC has been following.

4. Analysis of the Accounting Treatment

There are various reasons that may support PEC's accounting treatment of contributed facilities.

- Historical Treatment up to 1986 per the Tax Code – Prior to the Tax Reduction Act of 1986 ("1986 TRA"), contributions in aid of construction were treated as a balance sheet item, either reducing the cost of the constructed plant, or maintained as a contra entry on the balance sheet to reflect it as cost free capital in a regulated environment. The 1986 TRA changed the accounting treatment to a current income item. However, since PEC is a non-taxable entity, this treatment would seem to have no relevance to PEC's circumstances.

- Purpose of Third Party Construction of Assets – In 1996, a special provision was made for the tax treatment of these constructed infrastructure assets for water and sewer funds, reverting the treatment back to accounting for the assets as contributed capital. The basis of this treatment is more similar to PEC's circumstances in that the investments made by the third party developer were for the purpose of providing value to the purchaser of the property. The purchaser of the property would become a member of the cooperative upon initiating service. Accordingly, this is an investment on behalf of the member, but without direct assignment to the member, and accordingly, does not need to be tracked as part of the member's capital credits.

- Acceptance of an Obligation for the Benefit of the Member or Community – As part of accepting the contributed assets, the utility takes on the responsibility for maintaining the assets and ultimately, replacement of the assets should they deteriorate past being useful in the provision of service. Accordingly, these contributions were not to be treated as current period income because the property contribution had implications on future years' operations.

- Follows the "Original Cost Tenet" applied to Regulated Utilities – This accounting treatment allows plant in service to be recorded at its original cost of construction in the utilities' continuing property records and keeps that original cost identifiable for retirements, depreciation studies, and various other studies. This is an advantage in that it allows utilities to perform the various types of studies that are typically done to establish value, such as Original Cost Less Depreciation, and Reproduction Cost New less Adjustment of Age and Condition. Although these studies do not influence rate setting, they are used for the establishment of values for any transaction involving a sale, merger, or exchange of assets, and for the recovery of damages to facilities.

- No effect on Rates in a Regulated Setting – This accounting treatment does not affect the development of cost-based rates, in that the depreciation expense is being offset by an amortization of the contributed capital value. Accordingly, this treatment satisfies generally accepted accounting principles for regulated entities, or entities that establish rates based on costs of providing service.

B. Work Performed

Navigant Consulting researched the accounting treatment utilized by PEC including identifying the origins of the change in accounting practice and relevant communications between PEC and its outside auditors over the years in support of the accounting treatment. In addition, Navigant Consulting interviewed various PEC employees, including the CFO, regarding the history of the accounting treatment and the rationale for the change in 1997. Navigant Consulting further reviewed the impact of the accounting treatment relative to the value of assets (i.e., total utility plant in service) and membership equity in PEC's financial statements.

C. Observations and Findings

1. PEC's Accounting Treatment is Accepted as GAAP

In April of 2008, PEC accounting staff held a conference call with representatives from their external auditors, KPMG, and with the Director of Tax, Finance and Accounting Policy for the National Rural Electric Cooperative Association ("NRECA"). Based on that discussion, it was determined that while PEC may be the only cooperative applying this accounting treatment, it is in compliance with GAAP, and as long as there is no rate impact from depreciation expense, the accounting treatment is appropriate.

Additionally, in the same conference call, KPMG and NRECA agreed that the assets constructed and contributed by the developer (the original member) were left with PEC to maintain on behalf of the new member, but were not transferred to the new member. Accordingly, the assets belong to PEC, but on behalf of the PEC membership at large.

Navigant Consulting has reviewed the available literature and traced the history of the accounting treatment and has determined that there is no adverse impact on rates, nor any misrepresentation of the value of the assets recorded as plant in the utility's continuing property records.

2. PEC's Equity Ratios Relative to Other Cooperatives are Skewed

While PEC's accounting treatment is deemed acceptable by both its outside auditor and accounting staff at the NRECA, the resulting increase in equity makes comparisons with other cooperatives, as well as benchmarks and guidelines provided by the NRECA based on a cooperative's equity and equity ratio, less meaningful. As cited in a subsequent section of this Report regarding PEC's patronage capital and the payment of capital credits, PEC bases the decision to pay capital credits on its equity ratio (total member equity divided by total utility plant in service). However, when that policy was first developed by PEC in 1987, or perhaps earlier, PEC did not have a significant amount of contributed capital and, as referenced above, did not change its accounting treatment until 1997.

This approach has the effect of increasing member equity and leads to a larger equity ratio, thereby bringing PEC closer to achieving its benchmark 40% equity ratio for the payment of capital credits. However, PEC's true "member equity" or patronage capital is significantly less. As cited previously, part of PEC's justification for a 40% equity ratio was the NRECA's study on capital credits that recommended a ratio of between 30 - 50%. However, given that no other cooperatives reportedly utilize the same accounting treatment as PEC, the guidelines were likely targeted at member equity excluding any contributed capital. Likewise, the Cooperative Finance Corporation ("CFC") prepares annual reports in their Key Ratio Trend Analysis that rely on the member equity numbers reported by PEC.

Adjusting PEC's member equity to exclude contributed facilities, lowers the equity to total utility plant ratio to 19%, versus the 28% and the equity to total assets ratio to 20% versus the 31% reported for 2007. A summary of PEC's equity ratio as adjusted for the period 1998 – 2007 is provided in the table below:

Summary of Effect of Contributed Capital on PEC's Equity Ratios for 1998 - 2007

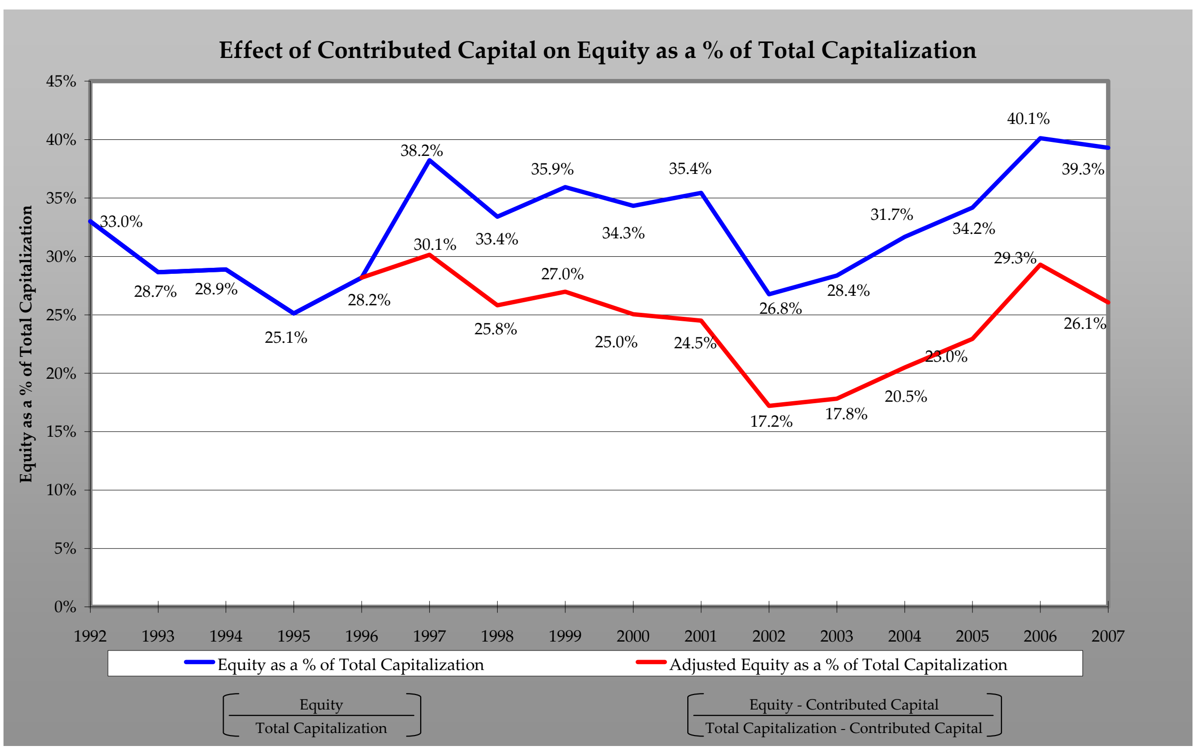
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Equity to Total Utility Plant	29.92%	29.34%	27.74%	27.36%	29.13%	28.54%	29.89%	29.92%	34.31%	28.48%
Adjusted Equity to Total Utility Plant*	24.02%	22.78%	21.06%	19.86%	20.52%	19.44%	20.65%	21.16%	26.05%	19.09%
Difference	5.90%	6.56%	6.68%	7.50%	8.61%	9.10%	9.24%	8.76%	8.26%	9.39%
Equity as a % of Assets	30.35%	31.37%	29.07%	29.50%	24.08%	25.60%	28.36%	30.02%	35.50%	30.75%
Adjusted Equity as a % of Assets	23.59%	23.71%	21.47%	20.91%	16.03%	16.59%	18.74%	20.44%	26.04%	20.04%
Difference	6.75%	7.66%	7.60%	8.59%	8.05%	9.01%	9.63%	9.58%	9.46%	10.71%

* Adjusted Equity to Total Utility Plant is calculated as: $\left[\dfrac{\text{Total Membership Equity - Contributed Capital net of Depreciation}}{\text{Total Utility Plant in Service - Contributed Capital before Depreciation}}\right]$

In addition, PEC's equity as a % of total assets, equity as a % of total capitalization, rate of return on equity and debt to equity ratios after adjusting for contributed facilities relative to the median value of other cooperatives who have supplied information to CFC is summarized in the table below:

Summary of Select Ratios Excluding Contributed Capital for 1998 - 2007 from CFC Key Ratio Trend Analysis										
Equity as a % of Total Assets	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
PEC (adjusted for Contributed Capital)	**23.59%**	**23.71%**	**21.47%**	**20.91%**	**16.03%**	**16.59%**	**18.74%**	**20.44%**	**26.04%**	**20.04%**
Large Co-ops Median	41.30%	39.69%	39.38%	37.83%	38.62%	39.05%	38.54%	37.13%	37.10%	35.83%
U.S. Co-ops Median	43.84%	43.33%	42.88%	43.55%	43.34%	43.29%	42.78%	42.32%	42.01%	41.14%
Texas Co-ops Median	43.40%	42.30%	44.67%	44.73%	44.00%	44.38%	43.95%	41.69%	43.25%	43.01%
Equity as a % of Total Capitalization										
PEC (adjusted for Contributed Capital)	**25.82%**	**26.99%**	**25.05%**	**24.50%**	**17.21%**	**17.83%**	**20.49%**	**22.95%**	**29.31%**	**26.07%**
Large Co-ops Median	44.40%	43.78%	43.59%	41.83%	43.88%	44.59%	43.83%	42.23%	43.64%	41.83%
U.S. Co-ops Median	48.70%	48.32%	47.77%	48.20%	48.73%	48.60%	48.20%	47.82%	47.27%	47.26%
Texas Co-ops Median	50.27%	48.34%	49.55%	50.83%	50.64%	48.72%	47.83%	47.15%	48.86%	49.19%
Rate of Return on Equity										
PEC (adjusted for Contributed Capital)	**8.63%**	**3.36%**	**1.70%**	**4.24%**	**10.18%**	**1.38%**	**13.32%**	**11.39%**	**26.13%**	**10.03%**
Large Co-ops Median	9.24%	6.76%	6.78%	8.49%	8.26%	7.33%	6.32%	6.70%	8.17%	8.59%
U.S. Co-ops Median	6.83%	5.71%	5.74%	6.01%	6.56%	5.85%	5.86%	6.08%	6.51%	7.03%
Texas Co-ops Median	6.96%	4.44%	5.96%	5.22%	7.49%	7.46%	5.75%	5.95%	8.29%	8.15%
Debt to Equity										
PEC (adjusted for Contributed Capital)	2.93	2.90	3.25	3.40	4.89	4.71	3.97	3.44	2.48	3.19

Contributed facilities also have an effect on the equity as a % of total capitalization ratio. A graph summarizing PEC's equity as a % of total capitalization ratio excluding contributed capital is provided below:



As depicted in the graph above, PEC's equity ratio based on member equity with contributed capital excluded was trending downward through the1990s. In the early part of this decade, this fact was obscured by PEC's treatment of contributed facilities in its equity ratios. However, as noted, PEC's equity ratio gradually began to improve over the next five years as PEC realized higher net margins and patronage capital at year-end, including a significant net margin in 2006.

D. Recommendations

Evaluate Accounting Treatment and Impact on Financial Ratios

- Given the relative significance of the value of contributed facilities carried on PEC's financial statements, the impact of PEC's equity related financial ratios, and the current differences of opinion regarding the appropriate treatment of contributed facilities, it is recommended that PEC evaluate and seek relevant third-party advice as to the most reasonable approach in connection with the accounting treatment of contributed facilities.

X. Patronage Capital/Capital Credits Payment Policy

A. Background

1. Class Action Lawsuit Complaint

A central complaint in the member class action lawsuit was PEC's "failure to retire Patrons' capital and/or return any excess revenue received [by PEC] from the members."[112] The Plaintiffs in the class action lawsuit cited PEC's reported $164,392,487 in Patronage Capital as of December 31, 2005, as well as an additional $33,000,000 in a reserve fund and $9,000,000 in a contingency fund as evidence of surpluses that could be distributed, and questioned why PEC had failed to return any of those funds to its members over the years.

2. Overview of Patronage Capital (i.e., Capital Credits)

As a cooperative, PEC is owned by its members. A member is anyone that agrees to purchase electric service through PEC and is willing to abide by the conditions of membership. Members are also "patrons" of the Cooperative in the sense that they do business with PEC through the purchase of electric service. Patrons' capital or "Patronage Capital" (also referred to as "capital credits"), is defined as "PEC's retained excess of revenues over expenses that have been allocated annually to its members…"[113] In other words, Patronage Capital is essentially the difference between PEC's operating revenues and expenses (i.e., net margin) each year, which is accumulated and allocated to the members over the years as their equity participation in the Cooperative.

3. Regulatory Framework

PEC is organized pursuant to the Electric Cooperative Corporation Act of the Texas Utilities Code, Chapter 161 (the "Texas Electric Cooperative Act").[114] Pursuant to the Texas Electric Cooperative Act, an electric cooperative is defined as a "Nonprofit Operation" that "shall operate without profit to its members." The Texas Electric Cooperative Act goes on to explain the fundamental principles by which electric cooperatives should be governed, including the following:

> *(b) The rates, fees, rents, and other charges for electric energy…services furnished by the cooperative must be sufficient at all times to:*
>
> > *(1) pay all operating and maintenance expenses necessary or desirable for the prudent conduct of the business;*
> > *(2) pay the principal of and interest on the obligations issued or assumed by the cooperative…; and*
> > *(3) create reserves.*

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[112] Plaintiffs' First Amended Petition, John Worrall, et al. v. Pedernales Electric Cooperative, Inc., et. al., p. 29.

[113] Pedernales Electric Cooperative, Inc., Consolidated Financial Statements (audited), as of June 30, 2006, Notes to Consolidated Financial Statements, Note 1 (n) Patronage Capital.

[114] Electric Cooperative Corporation Act, Tex. Util. Code Ann. § 161.001, et seq. (Vernon 1997).

(c) The cooperative shall devote its revenues:

(1) first to the payment of operating and maintenance expenses and the principal and interest on outstanding obligations; and
(2) then to the reserve prescribed by the Board for improvement, new construction, depreciation, and contingencies.

(d) The cooperative shall periodically return revenues not required for the purposes prescribed by Subsection (c) to the members…

These principles are also espoused in Article VIII of PEC's Bylaws including:[115]

Section 1…The Cooperative shall at all times be operated on a cooperative nonprofit basis for the mutual benefit of its patrons.

Section 2…In the furnishing of electric energy or other services the Cooperative's operations shall be so conducted that all patrons…will through their patronage furnish capital for the Cooperative.

All such amounts in excess of operating costs and expenses…are received with the understanding they are furnished by the patrons…as capital.

If the Board of Directors determines that the financial condition of the Cooperative will not be impaired thereby, the capital then credited to members' accounts may be retired in full or in part.

In order to qualify for nonprofit status pursuant to Internal Revenue Code Section 501 (c)(12), a cooperative must operate "at cost," meaning no profit. However, in recognizing that cooperatives, like most other businesses, have a need to maintain certain reserves, as well as to invest additional capital in new property, plant and equipment, the IRS code allows cooperatives to allocate the excess margins to its patrons in the form of capital credits.[116]

Cooperatives, like any other business, need capital to operate, which is usually supplied by a combination of debt from various financial sources (e.g., loans, bonds, etc.) or through equity (i.e., investments by owners in the business). The Patronage Capital held by the cooperative is essentially one of its primary sources of capital for the continued funding of the day-to-day operations and growth of the cooperative. Thus, a cooperative may have net margins in a particular year that are credited to its members' capital accounts, while at the same time it may lack sufficient cash flow to support an actual distribution of Patronage Capital.

[115] Bylaws for Pedernales Electric Cooperative, Inc., effective as of November 2007.

[116] IRS Revenue Ruling 72-36 also allows a cooperative to establish and maintain "reasonable reserves" for legitimate business purposes, such as plant expansion or the repayment of debt, among others. The ruling also prohibits the unnecessary accumulation of capital beyond the reasonable needs of the cooperative.

4. LCRA, REA and NRECA Guidance on Capital Credits

Various factors affect a cooperative's decision to retire capital credits (i.e., the return of some portion of its net margins to its members). Chief among these is a cooperative's financial strength and performance. Inherent in this factor are considerations including the cooperative's ongoing capital needs, the cost and availability of capital, and regulatory and financial debt service requirements, among others.

As early as the 1960s, and perhaps before, the LCRA, as the entity contractually engaged to conduct PEC's operations on behalf of its members at the time, provided guidelines for PEC's consideration in determining when to return or refund capital credits to its members. In providing this guidance, the LCRA also referenced principles established by the Rural Electrification Administration ("REA," now the Rural Utilities Service "RUS"), the federal authority that administers federal oversight of the electric cooperative industry through the U. S. Department of Agriculture. These principles included:[117]

- The importance of considering the impact that any refund of capital credits would have on rates, and the ability of the cooperative to grow and provide service.
- REA recommendations that adequate working capital and reserves be established to ensure that the Cooperative's objectives are met and that it can repay its debt.
- The principle that, once adequate working capital and reserves are established, the Cooperative "establish a cushion" by making advance payments on its long-term notes.
- The prerequisite that the Board of Directors determine that the financial condition of the Cooperative will not be "affected adversely" by a distribution.

The National Rural Electric Cooperative Association ("NRECA") likewise currently provides guidance on the payment/return of capital credits. In a 2005 Capital Credits Task Force Report, the NRECA noted various factors influencing a cooperative's decision to pay capital credits, including the cooperative's *financial performance, equity management plan, rate competitiveness, regulatory and lender requirements, views of the financial markets, expectations of the members, and impact on public relations*.[118]

[117] Inter-office Memorandum from Doughty L. Miller, Assistant Controller and Administrative Assistant, Lower Colorado River Authority, to Ben Fuelberg, District manager, Subject: Capital Credits plan of operation, dated February 11, 1966.

[118] Capital Credits Task Force Report, A Distribution Cooperative's Guide to Making Capital Credit Decisions, National Rural Electric Cooperatives Association, January 2005.

5. PEC's Patronage Capital Account

PEC began recording capital credits in 1960.[119] As of December 31, 2007, PEC had approximately $215,681,304 in Patronage Capital credited to the capital accounts of the members, with an additional $35,000,000 in a reserve fund and $10,500,000 in a contingency fund. PEC defined Patronage Capital in the notes to its 2006 consolidated financial statements as representing "…PEC's accumulated retained excess of revenues over expenses that have been allocated annually to its members based upon a member's total annual purchases of electricity to total annual PEC sales of electricity, in accordance with PEC's bylaws."[120]

B. Work Performed

With regard to the questions raised concerning PEC's Patronage Capital and the payment of capital credits to its members, Navigant Consulting evaluated PEC's existing and historical capital credits payment policies in light of the various factors that generally should influence such decisions. More specifically, Navigant Consulting focused on the following questions:

1. Did PEC's historical financial performance place it in a position to be able to pay capital credits over time?

2. Does PEC have a current policy with regard to the payment of capital credits and has it been followed over the years?

3. Was PEC's policy reasonable in light of commonly observed industry standards?

4. Has PEC been subject to debt covenants or other requirements imposed on it by its lenders or bond-holders that have influenced PEC's ability to pay capital credits?

5. Was PEC's policy reasonable in light of its past financial performance and perceptions of its performance by the investment community (i.e., rating agencies)?

6. Would the payment of capital credits in the past have had an impact on the Cooperative's rate competitiveness?

7. Is PEC's equity management plan and policy regarding the payment of capital credits reasonable in comparison to other cooperatives?

To address these questions, our work entailed the following:

[119] Although the cooperative had been in existence since 1938, the Board did not believe that the financial condition of the Cooperative was sufficiently strong to allow for the recognition and tracking of capital credits until 1960.

[120] Pedernales Electric Cooperative, Inc. Audited Financial Statements as of December 31, 2006.

- Reviewing past Board meeting minutes and discussions in relation to the establishment and following of PEC's policy on the payment of capital credits.
- Analyzing PEC's past financial performance giving rise to the existing balance of Patronage Capital including historical growth, service and rate competitiveness.
- Analyzing PEC's accumulation of Patronage Capital and allocation of that capital to its members.
- Reviewing PEC's long-term debt financing and the restrictions imposed by its various bond indentures regarding the payment of capital credits, as well as the impact of the rating agencies on PEC's policy.
- Assessing industry guidance provided by various industry associations.
- Comparing the practices of other cooperatives regarding the payment of capital credits.

C. Observations and Findings

As described above, various factors influence the decision to return or refund capital credits to a cooperative's members. Principal among these are financial considerations, such as the availability of cash to make payments, the need for additional sources of funds to meet ongoing debt obligations and to finance future new construction and growth of the cooperative, as well as the need to balance the debt and equity levels of the cooperative to maintain its creditworthiness.

1. PEC's Financial Performance

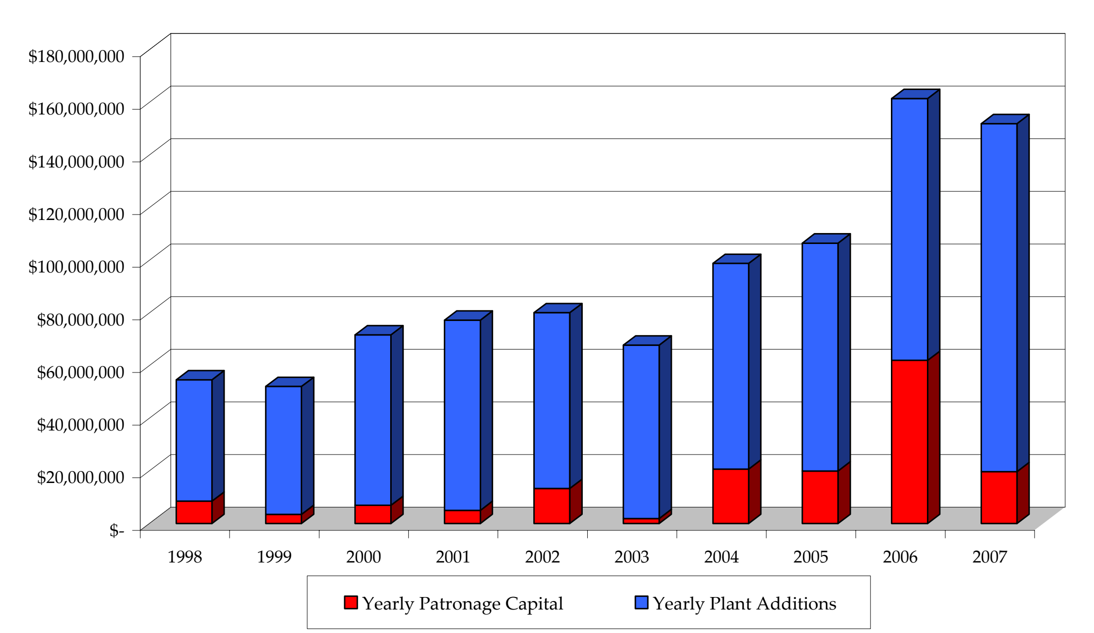
As previously described, PEC has had significant growth over the past ten years. The Cooperative's growth and overall financial performance has inhibited its ability to return Patronage Capital through the payment of capital credits. Significant growth requires significant additional capital investment for the building of new electric distribution lines, substations, District and branch offices, and other infrastructure in order to continue providing quality service to the Cooperative's members.

Patronage Capital is one of the primary sources of funding for a cooperative in financing such growth. While Patronage Capital alone has not been a sufficient capital source to support the rapid increase in both the geographic size of PEC and the number of members it serves, it has been an important source of capital for the Cooperative. Patronage Capital has more than doubled over the past ten years from approximately $93 million in 1998 to $216 million in 2007. PEC's long-term borrowing likewise increased from approximately $281 million to $556 million during the same time period. The table below illustrates these increases in Utility Plant, Patronage Capital, and Long-Term Debt over the ten-year period.

Summary of PEC Consolidated Balance Sheets Information - Total Utilty Plant, Patronage Capital and Long-Term Debt (In Thousands)										
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Utility Plant	$ 461,904	$ 510,043	$ 594,150	$ 671,633	$ 744,496	$ 809,222	$ 890,797	$ 976,391	$ 1,080,543	$ 1,219,635
								Change: 1998 - 2007		*$ 757,731*
Patronage Capital	93,472	96,894	103,761	108,684	121,968	123,815	144,469	164,392	226,360	215,681
								Change: 1998 - 2007		*$ 122,209*
Long-Term Debt (Net of Current)	$ 281,365	$ 275,297	$ 328,884	$ 357,726	$ 628,089	$ 615,219	$ 601,630	$ 587,271	$ 572,081	$ 556,024
								Change: 1998 - 2007		*$ 274,659*

While Patronage Capital has increased by approximately $122 million, PEC has made capital investments in new utility property, plant and equipment totaling over $750 million to keep up with the Cooperative's growth, with the excess coming from borrowing. Absent the retention of the net margins allocated as Patronage Capital to its members, PEC would have needed to take on significantly higher levels of debt than it did during this period in order to finance its investments in infrastructure. In effect, one dollar less of Patronage Capital results in one dollar more in borrowing. The trade-off between returning a dollar of Patronage Capital versus using it to help support the growth of the Cooperative is apparent given the relative size of PEC's yearly capital investment to support its growth, as illustrated in the bar chart below:

Summary of Yearly Patronage Capital and Yearly Plant Additions (1998 - 2007)



A cooperative's capital structure (i.e., the relationship between the total amount of equity versus debt used to finance the cooperative) is as important for a cooperative as it is for most other corporations. The proportion of debt to equity is a key performance metric in gauging the relative financial soundness of the business and is often used as a benchmark in determining a cooperative's access to debt capital, as well as the cost of that capital. Most companies work to achieve a desired capital structure (as expressed by the entity's equity ratio or debt-to-equity ratio), and PEC has typically not been any different. PEC's desired capital structure has been, and continues to be, a 40% equity ratio (i.e., defined as 40% total equity relative to total utility plant).

A cooperative's equity comes from its members. Therefore, as a cooperative grows, it needs proportional amounts of new equity along with its debt burden in order to maintain its desired capital structure. PEC has had the same targeted objective of a 40% equity level for many years. However, given PEC's continued and rapid growth, to our knowledge it has never achieved a 40% equity level, as it historically has had insufficient net margins, in comparison to its infrastructure needs, which have necessitated significant amounts of debt.

Notwithstanding its failure to achieve its 40 % equity target, PEC has had strong financial performance, primarily over the last four years, and has been in a position to repay capital credits (consistent with the requirement of the settlement of the class action lawsuit). Even so, a decision by PEC to retire capital credits, either earlier in its history, or as now committed to under the requirement of the Settlement Agreement, would have and does entail the type of trade-off described above—with fewer retained earnings to apply to capital investments, these distributions must effectively be funded through additional borrowing.

2. PEC's Capital Credits Payment Policy

Based on our analysis of PEC's capital credits payment policy, in each year from 1998 - 2007 PEC has adhered to a policy established by the Board in 1987 in determining whether to return capital credits to its members. PEC's guidelines with respect to Patronage Capital and the tracking and potential return of capital credits are outlined in PEC's Articles of Incorporation and Bylaws, as previously described. However, the fundamental benchmark by which PEC has gauged whether it would return capital credits to its members is a policy established by the Board in 1983 (or perhaps earlier), and subsequently modified and reaffirmed in 1987.[121] PEC's policy is summarized below:

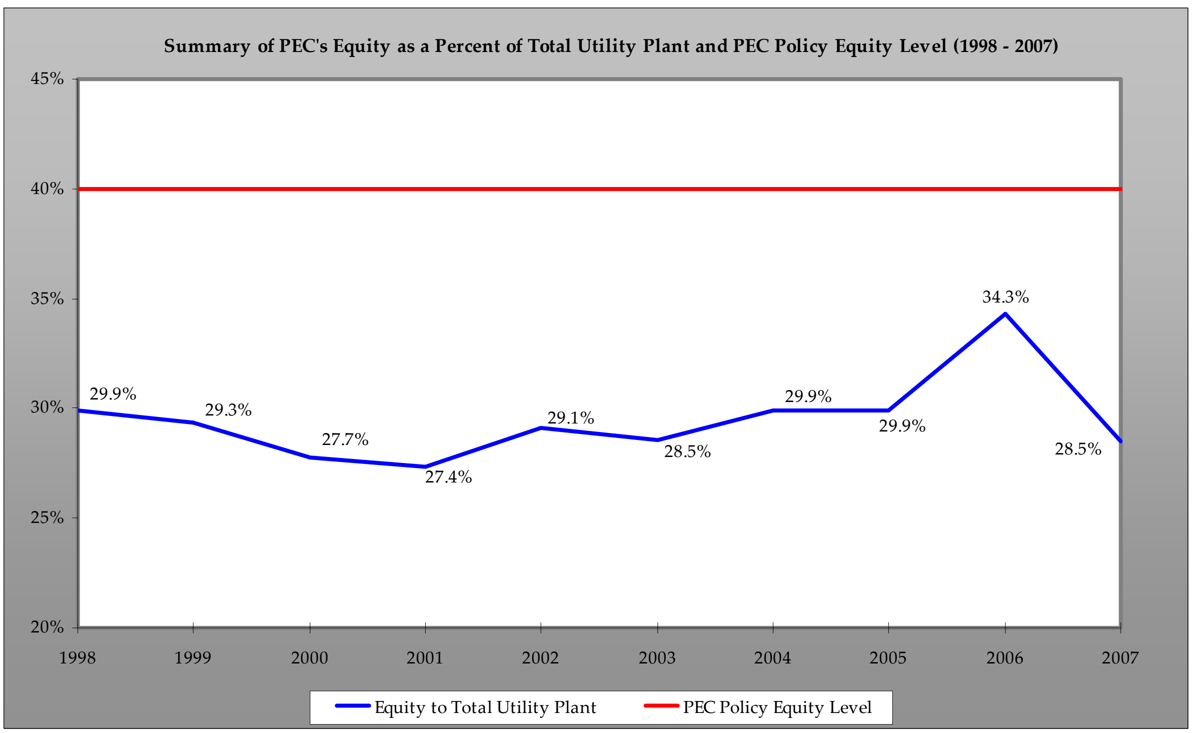
> *That the policy of the Cooperative continue to be that patronage capital will be reinvested in utility plant and will not be returned to the membership in the form of capital credit payments until such time that the members' equity in the system reaches at least **40% of total utility plant** [emphasis added] in service and until such time that the Board of Directors deems a return of patronage capital to be in the best interests of the Cooperative.*

As defined, PEC's benchmark focuses on the dollar value of member equity (which includes the value of membership certificates, Patronage Capital and contributed facilities) as a percentage of the dollar value of PEC's total utility plant. PEC's policy essentially states that when "member equity" reaches a value that is 40% of total utility plant, it will pay capital credits (if deemed by the Directors to be in the best interests of the Cooperative). PEC's calculated equity ratio is summarized below:

[121] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., November 21, 1983, and the Special Called Organizational Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 20, 1987.

PEC's Member Equity and Defined Equity Ratio	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					(in thousands)					
Utility Plant	$ 407,775	$ 446,694	$ 522,053	$ 584,687	$ 636,216	$ 686,713	$ 751,051	$ 826,790	$ 910,481	$1,027,125
Contributed facilities (before depr.)	54,129	63,348	72,097	86,946	108,280	122,509	139,745	149,601	170,063	192,510
Total Utility Plant	$ 461,904	$ 510,043	$ 594,150	$ 671,633	$ 744,496	$ 809,222	$ 890,797	$ 976,391	$1,080,543	$1,219,635
Membership Equity Accounts										
Membership equity:										
Membership certificates	$ 4,468	$ 4,861	$ 6,160	$ 7,414	$ 8,584	$ 9,649	$ 10,588	$ 10,561	$ 10,822	$ 11,438
Contributed facilities	40,251	47,915	54,881	67,645	86,336	97,479	111,183	117,196	133,513	151,273
Patronage capital	93,472	96,894	103,761	108,684	121,968	123,815	144,469	164,392	226,360	215,681
Total membership equity	$ 138,191	$ 149,670	$ 164,801	$ 183,743	$ 216,888	$ 230,943	$ 266,241	$ 292,150	$ 370,694	$ 347,343
PEC's Defined Equity Ratio										
Member equity to Utility Plant	**29.9%**	**29.3%**	**27.7%**	**27.4%**	**29.1%**	**28.5%**	**29.9%**	**29.9%**	**34.3%**	**28.5%**

As detailed above and depicted in the graph below, PEC has not reached the 40% equity ratio, as defined, during the past ten years.



Alternative methods can be used for calculation of an equity ratio, taking into account differences between member equity and patronage capital, and between total utility plant and total assets. For purposes of evaluating capital credits, PEC currently calculates this benchmark as 40% of total utility plant (before depreciation), which is greater than "total assets." For comprehensiveness, our analysis focused on evaluating PEC's ability to pay capital credits in light of various interpretations of PEC's equity ratio policy including 1) 40% of total assets, 2) 40% of total utility plant, and 3) 40% of net utility plant (after depreciation).

In addition, member equity as accounted for by PEC includes contributions in aid of construction or "contributed facilities," which, based on our understanding, is different from how most cooperatives account for this item. Contributed facilities consist primarily of facilities constructed by real estate developers and donated (i.e., contributed) to PEC. Most cooperatives do not appear to account for contributed facilities in a way that results in the creation of member equity. The proper accounting treatment of contributed facilities is currently open for debate, with each of the two treatments seemingly accepted by certain accounting firms at this time. PEC's treatment of contributed facilities as a component of equity has been supported by KPMG, its outside auditing firm, since 1997.

PEC's treatment of contributed facilities has the effect of benefiting the members by including this as an item of member equity. As such, without the addition of the sizable value of contributed facilities, PEC's member equity would have averaged closer to 20% of total utility plant in the past ten years, which is half of PEC's stated 40% equity ratio guideline, rather than 30%. PEC's calculated equity ratio, as well as other ratios evaluated in our analysis, is summarized in the table below:

PEC Ratio Analysis from Audited Financial Statements for 1998 - 2007*

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Membership Equity to Total Utility Plant	***29.9%***	***29.3%***	***27.7%***	***27.4%***	***29.1%***	***28.5%***	***29.9%***	***29.9%***	***34.3%***	***28.5%***
Patronage Capital and Member Certificates (w/o contributed facilities) to Total Utility Plant	24.0%	22.8%	21.1%	19.9%	20.5%	19.4%	20.6%	21.2%	26.1%	19.1%
Patronage Capital and Membership Certificates to Net Utility Plant in Service	25.0%	23.6%	22.0%	20.6%	20.9%	19.9%	21.1%	21.9%	26.9%	22.7%
Total Membership Equity to Total Assets	30.3%	31.4%	29.1%	29.5%	24.1%	25.6%	28.4%	30.0%	35.5%	30.7%
Total Membership Equity to Net Utility Plant in Service	35.3%	34.7%	33.0%	32.6%	34.8%	34.4%	36.2%	36.6%	42.1%	34.8%

* 2007 financial statements are unaudited.

Regardless of the method by which the ratio is calculated, PEC's member equity has not exceeded 40% of total assets or total utility plant in any year from 1998 - 2007, with the exception of the results under one method of calculation in 2006. The chart also reflects that the relationship of PEC's utility plant asset base as compared to member equity, by various measures, has remained relatively stable during the past ten years, with the exception of 2006, a year of significant net margins.

In November 2007, the Board reaffirmed the 40% member equity ratio target as set forth in 1987 and established that, when appropriate, the Board would retire capital credits on a first in-first out basis, starting with the return of capital credits through 1976 and thereafter on a 30-year rotation.[122] However, that retirement schedule has been preempted by the Patronage Capital retirement commitment made in connection with the settlement of the class action lawsuit. Pursuant to the Settlement Agreement, PEC agreed to retire approximately $23 million in Patronage Capital over a

[122] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., November 9, 2007.

five-year period starting in 2008. The first $4.6 million in capital credits was disbursed in October, 2008.

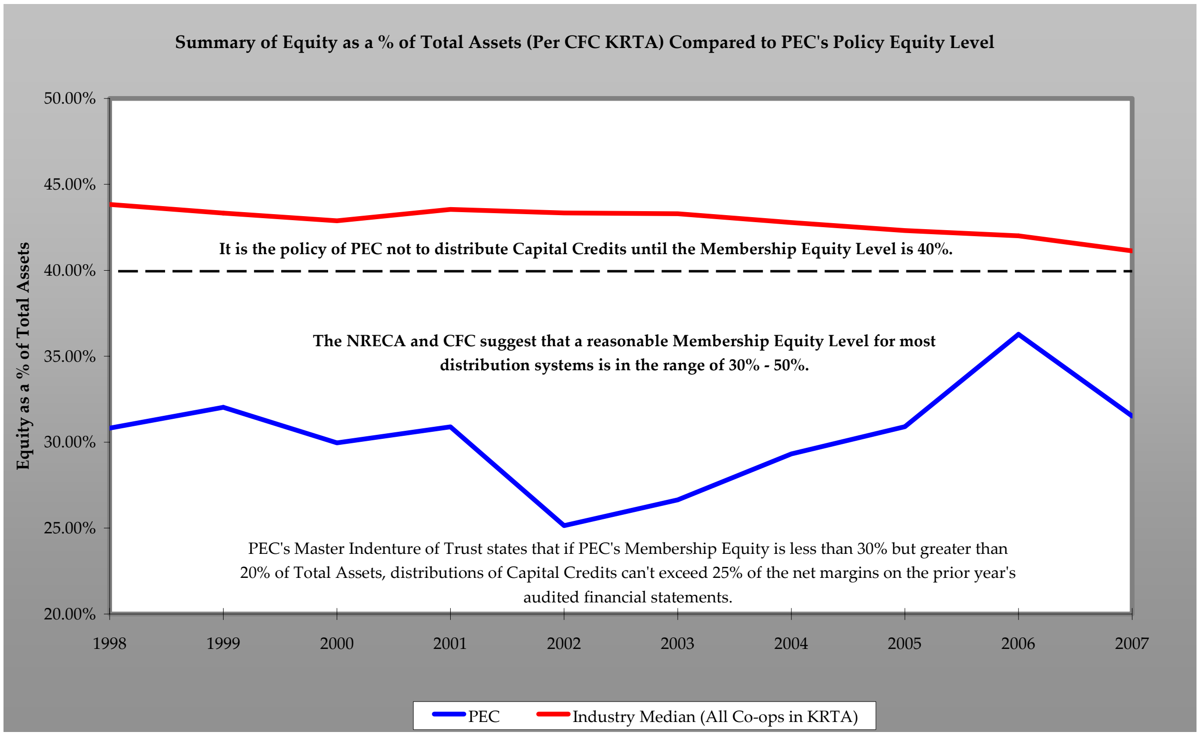
3. Industry Guidance on Payment of Capital Credits

In January 2005, the National Rural Electric Cooperative Association ("NRECA") published a report after a year-long study on capital credits in relation to electric distribution cooperatives. Based on the results of that study, NRECA suggested that a reasonable equity level for most electric distribution cooperatives is in the range of 30 to 50 percent (of total assets), depending on the cooperative's financial and competitive situation.[123] In supporting its recommendation, NRECA cited an earlier NRECA study published in 1976 that recommended a minimum equity level of 30% to "ensure access to capital" and to maintain financial strength. NRECA reiterated its recommendation regarding a 30% minimum equity level in the 2005 study.

In addition, as described further below, NRECA report also cites that Fitch Ratings ("Fitch"), a well-known financial rating agency, in its analysis of electric cooperatives typically looks for 30 to 50 percent equity for an investment grade rating of the entity's bonds, which is consistent with NRECA's recommendations.

Assuming the NRECA's definition of an equity ratio relative to total assets versus PEC's calculation against total utility plant, and a minimum recommended equity level of 30%, PEC would have qualified for payment of capital credits in seven of the ten years during the period 1998 - 2007, but only by a small margin in six of those years. As depicted in the graph below, even assuming the minimum recommended ratios, PEC's equity ratio would have been insufficient to warrant the payment of capital credits in most years during the period under investigation. Likewise, it is noteworthy that PEC's equity ratios were significantly below those of comparable cooperatives during the same time period.

[123] Capital Credits Task Force Report, A Distribution Cooperative's Guide to Making Capital Credits Decisions, National Rural Electric Cooperative Association, January 2005.



4. Lender Restrictions on PEC's Payment of Capital Credits

In addition to the internal guidelines established by PEC's Board in 1987, PEC also has been subject to limitations on the payment of capital credits imposed on it by its lenders and through its bond indentures. In general, certain limitations in bond and debt covenants attempt to preserve the sound financial condition of the entity in order to ensure, or at least not impair, a cooperative's ability to repay the required interest and principal payments on its outstanding indebtedness. Certain covenants in PEC's bond indentures are consistent with this principle.

To support its substantial growth over the past ten years, PEC has relied heavily on various financial sources, including access to borrowing through the Cooperative Finance Corporation ("CFC") and through the issuance of bonds in the public bond markets. Over the years, each of these funding sources has placed certain limitations on PEC's ability to return capital credits. During the period 1998 - 2007, PEC had outstanding long-term debt obligations in the form of mortgage bonds and notes in excess of $550 million. A summary of PEC's historical long-term debt is provided in Exhibit 2.

The most relevant limitations on retirement of capital credits are referenced in the Master and Supplemental Indentures in relation to the bonds, as well as in the Loan Agreement between PEC and CFC.[124] The combined restrictions generally allow PEC to distribute capital credits if:

- PEC is not in default, and does not have any unpaid installment or principal payments;
- PEC's current and accrued assets are greater than its current and accrued liabilities;
- Membership equity is greater than 30% of total assets; or
- If membership equity is less than 30% but greater than 20%, then any distribution may not exceed 25% of PEC's net margins for the previous year; and
- PEC obtains the prior consent of CFC.

While PEC's Board policy has been more restrictive than the general membership equity requirements from its lenders, any payments of capital credits that could have been paid under the standards established by these restrictive covenants, assuming approval from CFC, would nevertheless have been limited, with the exception of 2006, when PEC's net margins exceeded $60 million.

5. Rating Agency Perception of PEC's Financial Condition

In addition to the restrictions from PEC's lenders, the payment of capital credits is also effectively influenced by various other factors, including PEC's perceived financial condition and strength. PEC's corporate bonds, a financing source for the cooperative beginning in 1987, have been rated by various rating agencies over the years. The ratings provide an indication of the financial health of PEC and its ability to meet its financial commitments.

PEC debt instruments have been rated by Fitch, Standard & Poors ("S&P") and Moody's Investors Service ("Moody's") at various points in time. Bond ratings are important to investors in assessing the risk associated with a particular company and its bonds. They are also important to PEC because their reflection of PEC's financial condition impacts both PEC's access to the debt market and the potential cost of funds available in that market (i.e., the lower the rating, the higher the cost of borrowing).

Among other factors, the bond rating agencies have focused on various financial ratios including those implicating PEC's cash reserves and debt-service coverage, and its equity-to-capitalization ratio, all three being indicators of PEC's ability to continue meeting the demands of its significant growth; likewise, each of these ratios would be affected by the payment of capital credits. Relevant financial ratios include the following:

[124] Pedernales Electric Cooperative, Inc., Master Indenture of Trust (and First through the Fourth Supplemental Indentures of Trust), to the Bank of New York, as Trustee, dated effective as of January 1, 1993, in relation to CFC Mortgage Notes.

Summary of PEC Key Financial Ratios	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Cash Flow										
Debt-Service Coverage	1.81	1.55	1.54	1.9	2.27	1.32	1.66	1.67	2.46	1.66
Liquidity										
Current Ratio	2.01	0.83	0.9	0.61	1.46	1.9	1.52	2.15	2.05	0.77
Working Capital (000's)	25,684	(7,184)	(6,393)	(28,079)	20,834	65,102	59,394	72,683	66,577	(32,853)
Days Cash on Hand	244	23.5	29.9	13.1	46	101	75	84	n/a	n/a
Leverage										
Equity to Assets	30.81%	32.03%	29.96%	30.90%	25.14%	26.65%	29.32%	30.91%	36.28%	31.52%
Equity / Capitalization	33.40%	35.93%	34.33%	35.44%	26.76%	28.36%	31.67%	34.17%	40.12%	39.30%
Profitability										
Operating Margin	36.30%	29.20%	27.10%	23.40%	33.40%	29.51%	34.80%	32.42%	43.67%	27.47%
Net Margin	11.80%	4.30%	2.00%	4.70%	10.08%	1.33%	12.16%	11.61%	27.95%	10.17%

Source: Cooperative Finance Corporation (CFC) Key Ratio Trend Analysis (1998 - 2007) and Fitch Ratings Reports (Oct. 2002 and Feb. 2007)

From the late 1990s through the early part of the decade, PEC's use of debt to finance ongoing growth increased significantly. During the period 2001 through 2003, Fitch, Moody's and S&P all raised concerns about PEC's lack of liquidity (i.e., the low amount of available cash on hand to fund current operations), PEC's high debt load, and its low debt-service coverage ratio. In 2002, Fitch noted PEC's low cash reserves, which stood at only 13 days at the end of 2001. Also in 2002, Moody's changed its outlook on PEC's bonds from "stable" to "negative" citing PEC's high debt level. In 2003, Fitch noted PEC's low debt-service coverage ratio at 1.35 times (x). In 2004, while noting improved liquidity at PEC, S&P adjusted its rating to "negative" from "stable" as a result of concerns with PEC's debt-service coverage, which S&P deemed not commensurate with the more favorable rating.

In response, PEC took various steps to allay the concerns of the rating agencies relating to liquidity, including establishing both a $9 million "contingency" fund (which has since been increased to $10.5 million) and a $33 million "general" fund in 2002.[125] PEC also committed to trying to achieve and maintain a 1.7 times (x) debt-service coverage ratio going forward, as well as a target 30% equity ratio. As previously described, Fitch generally noted that a 30 to 50 percent equity ratio would be appropriate for an "investment grade" rating on bonds.[126]

PEC's level of debt, relative to member equity, has been, and continues to be, high in comparison to that of other cooperatives, a condition that has raised concerns regarding its ability to continue generating sufficient cash flow from operations to meet its ongoing growth without the need for continued increases in debt.

The concerns raised by the rating agencies during the 2001 to 2004 period were directly related to the amount of cash that PEC had available, concerns that would only have been exacerbated by the use of significant portions of that cash for the payment of capital credits. In light of PEC's assessment by the

[125] By resolution dated December 16, 2002, the Board of Directors approved the creation of a "contingency fund" equal to "not less than 1% of assets" to provide funds for "extraordinary operation and maintenance and contingencies"; and a voluntary "reserve fund equal to the highest principal and interest payment due in any year." The funds were created using proceeds from the 2002 bond offering.

[126] Bonds with "investment grade" ratings typically indicate relatively low to moderate credit risk.

various rating agencies in recent years, as well as in light of the recommended equity ratio, in all likelihood PEC would have been criticized by the financial community for any payment of capital credits over the past ten years. Any use of cash for the payment of capital credits would have resulted in even lower liquidity, lower debt-service coverage ratios and potentially higher debt costs and interest rates, which may have led to further rating adjustments that would not have been in the best interests of the Cooperative and its members.

6. Impact of Capital Credits on Rate Competitiveness

While a direct correlation does not exist between the payment of capital credits and PEC's competitiveness in electricity rates the two concepts are intertwined. The existence of excess margins (i.e., revenues in excess of operating expenses) implies that electric rates are higher than necessary to cover operating costs. Every cooperative must conduct a balancing act between ensuring sufficient excess margins (i.e., capital) are available to meet additional investment requirements and growth while still providing low rates to its members. If rates are too high, the cooperative will have more Patronage Capital than required, and if too low, the cooperative runs the risk of not having sufficient cash to meet its operating expenses and other obligations.

If PEC had adopted a policy of paying capital credits during the past ten years, in light of the identified liquidity and debt-service coverage concerns already noted, it is not unreasonable to assume that PEC would have needed to either 1) take on additional debt to pay for the capital credits and provide sufficient capital for operations, which would also ultimately have led to higher electric rates to cover PEC's debt service obligations, or 2) raise electric rates to rebuild the reserves and available cash used in payment of the capital credits.

7. Comparison to Other Cooperatives

The referenced 2005 NRECA report also recited that, based on 2003 Form 7 data reported to RUS and CFC, the composite average equity of distribution cooperatives exceeded 40%, and that 84% of eligible cooperatives were retiring capital credits. In addition, a limited survey conducted by Navigant Consulting in relation to this investigation also supports the conclusion that a high percentage of cooperatives have been retiring some level of capital credits in the recent past. NRECA's finding of a composite equity of 40% was also consistent with our analysis, which shows that the average equity ratio for cooperatives surveyed exceeded 40% in each of the last ten years.

As reflected in the Navigant Consulting survey, while larger cooperatives typically had smaller equity ratios on average, even the top 50 to 100 largest cooperatives had an average equity ratio of between 37% and 40%, which was significantly higher than PEC's ratio during the same time period.

PEC does not compare favorably with other electric cooperatives with respect to either its equity ratio or in relation to other financial ratios indicative of its ability to service long-term debt requirements. PEC has a significant level of debt relative to other cooperatives, and its relative proportion of debt to total capitalization is significantly higher on average than almost all other cooperatives. During the period 1998 - 2007, PEC's equity ratio (equity as a percentage of total assets) ranked at or below that of 75% of the other cooperatives, even the larger cooperatives.

Summary of Equity as a % of Total Assets for 1998 - 2007 from CFC Key Ratio Trend Analysis										
	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Equity as a % of Total Assets										
PEC	30.8%	32.0%	30.0%	30.9%	25.1%	26.7%	29.3%	30.9%	36.3%	31.5%
Industry Median	43.8%	43.3%	42.9%	43.6%	43.3%	43.3%	42.8%	42.3%	42.0%	41.1%
Industry Median (TX)	43.4%	42.3%	44.7%	44.7%	44.0%	44.4%	44.0%	41.7%	43.3%	43.0%
Industry Median (Large Co-ops)	41.3%	39.7%	39.4%	37.8%	38.6%	39.1%	38.5%	37.1%	37.1%	35.8%

The table above illustrates PEC's relatively low ranking for equity as a percentage of total assets compared to other cooperatives nationally. Even in comparison to other cooperatives in Texas, PEC is significantly below the median and the average in relation to various indicators of financial strength, including its equity ratio. An analysis comparing select PEC financial ratios to other cooperatives is attached as Exhibit 3.

8. Overall Findings

Given the concerns raised in PEC's recent past by the rating agencies, as well as limitations imposed on it by its lenders, and consistent with guidance received from the NRECA and with its performance ranking in this area compared to other cooperatives, PEC's equity management policy of foregoing the payment of capital credits until member equity reaches 40% of the value of its total utility plant appears reasonable and well-supported. PEC's ongoing significant growth, and its needs for continued substantial levels of debt to finance that growth, also supports PEC's current policy and the conservative nature of that policy in addressing future financial challenges of the Cooperative.

While PEC's current equity position is not sufficient to warrant the payment of capital credits, its equity position is a direct result of its expense management policies and inability to effectively control costs at the Cooperative over the years. In many respects, the significant issues raised regarding PEC's financial management, including the lack of budgets, expense management or other fiscal management policies and procedures, resulted in an environment where the lack of cost controls likely contributed significantly to PEC's lower net margins over the years. As discussed, PEC's controllable expenses per consumer or members, as well as a percentage of kWhs sold, were substantially higher than comparable cooperatives in its peer group. In addition, and as pointed out in subsequent sections of this Report, significant discretionary expenditures were incurred by PEC's former Senior Management and the Board over the years.

As noted above, PEC agreed, pursuant to the class action lawsuit settlement, to retire approximately $23 million in Patronage Capital over a five-year period starting in 2008.

D. Recommendations

Capital Credits Policy

- Navigant Consulting recommends that PEC undertake to revise its capital credits payment policy, as well as establish an equity management plan, consistent with the topics and recommendations made by the cited NRECA 2005 Capital Credits Task Force Report. Many of the topics discussed and recommended by the NRECA are applicable to PEC, especially in relation to the importance for a cooperative of establishing clear guidelines and policies in relation to managing Patronage Capital and establishing a capital credits payment policy.

- The NRECA 2005 Capital Credits Task Force Report emphasizes the importance of cooperatives having both an "equity management plan," which outlines the relevant financial metrics and considerations in managing member equity relative to other financial concerns, as well as a "capital credits payment policy," noting the significant relationship between the two. In this context, NRECA emphasizes the importance of evaluating and clearly establishing policies that address the appropriate balance between retaining capital credits and returning those benefits of ownership to the members.

- While PEC's past decisions to not pay capital credits appear reasonable, the Cooperative's decision-making process for this significant element of its operations merits some refinement. PEC's defined approach in relation to the payment of capital credits, based in part on its Articles of Incorporation and its Bylaws, has been based on the Board-approved 40% equity level of total utility plant, and to some extent on a lesser known "Policy Regarding Capital Credit Rotation" adopted in 1975.[127] PEC appears to have historically managed its financial condition, and indirectly its decision to pay capital credits, with reference to more financial ratios and metrics than just the 40% equity ratio (e.g., liquidity and debt-service coverage factors), yet the applied metrics do not appear to have been well-defined or articulated in any sort of "equity management plan" or "capital credits payment policy" or, for that matter, evaluated and discussed at the Board level. The NRECA report notes that "[e]stablishing a capital credits policy is one of the most important responsibilities of a co-op's Board of Directors."[128] We recommend that a capital credits policy be implemented as defined by the NRECA, a capital credits policy should outline the Board's strategic objectives in relation to the payment of capital credits, including defining the following elements:[129]

    » PEC's strategic goals for managing its capital credits;
    » What funds will be allocated to members;
    » How funds will be allocated;
    » How members will be notified of their allocations;
    » When PEC would consider retiring or returning capital credits to members;
    » How PEC would determine the amount of capital credits to retire;
    » Which retirement method to use;
    » Whether PEC would make special retirements (outside of the established policy, e.g., in connection with settlement of the estates of deceased members); and
    » What approach maximizes the value and benefits to PEC, as well as its members.

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[127] Pedernales Electric Cooperative, Inc., Policy Regarding Capital Credit Rotation, adopted by the Board of Directors October 1975.

[128] Capital Credits Task Force Report, A Distribution Cooperative's Guide to Making Capital Credits Decisions, National Rural Electric Cooperative Association, January 2005.

[129] Capital Credits Task Force Report, A Distribution Cooperative's Guide to Making Capital Credits Decisions, National Rural Electric Cooperative Association, January 2005.

Equity Management Plan

- Inherent in a good capital credits policy is also a strong equity management plan, which has the primary focus of determining how best to balance equity and debt effectively to meet a cooperative's needs, including:[130]

  » Maintaining financial strength,
  » Meeting outstanding debt requirements,
  » Funding new construction and growth,
  » Retiring capital credits, and
  » Ensuring fairness across generations.

- As described earlier in this Report, it is recommended that PEC use certain financial ratios and metrics to evaluate its relative financial strength and ability to meet its ongoing commitments to lenders and to its members. One of those metrics is PEC's relative use of debt versus equity in funding additional growth and the replacement of existing property and equipment. In addition, as already evidenced in reports from the rating agencies, PEC has a need for a continued, and better defined, focus on liquidity and debt-service coverage at levels sufficient to provide ongoing financial stability.

- We recommend that an equity management plan be implemented. Borrowing again in part from the NRECA report, a strong equity management plan should, at a minimum, consider the following:[131]

  » PEC's cost and availability of capital,
  » Loan and mortgage requirements of PEC's lenders,
  » Projected capital requirements for utility plant and other expansion/replacement,
  » PEC's competitive position in comparison to other cooperatives,
  » PEC's rate competitiveness relative to other cooperatives and public power utilities, and
  » PEC's ability to retire capital credits periodically to its members.

- In summary, the NRECA report recommended that "each electric cooperative should seek to maintain an equity level adequate to retire capital credits on an annual basis…" While PEC is currently not in a position to adhere to such recommendation for the various reasons described above, it is believed that such an objective is not without merit for inclusion in the equity management plan and capital credits payment policy recommended for development by PEC.

[130] Capital Credits Task Force Report, A Distribution Cooperative's Guide to Making Capital Credits Decisions, National Rural Electric Cooperative Association, January 2005.
[131] Capital Credits Task Force Report, A Distribution Cooperative's Guide to Making Capital Credits Decisions, National Rural Electric Cooperative Association, January 2005.

XI. Texland Electric Cooperative, Inc.

A. Background

The existence of a bank account in the name of Texland Electric Cooperative, Inc. ("Texland") was identified during the course of the investigation. Texland was an entity created in 1978 by Bluebonnet Electric Cooperative, Inc. ("Bluebonnet") and PEC, reportedly for purposes of evaluating an opportunity for PEC and Bluebonnet to build their own electric energy generation facilities in Milam County, Texas.[132] Available historical information indicates that this project, after several years of intensive development, was discontinued in the late 1980s. However, a bank statement in PEC's possession indicated that a non-interest bearing checking account (Acct. # 1003194) in the name of Texland was still in existence at Cattleman's National Bank ("Cattleman's") at the time of the investigation with an approximate balance of $565,350.[133] While the bank account was not in PEC's name, nor were the funds in the account recorded in the books and records of PEC, the bank statements were addressed to the attention of Mr. Fuelberg at PEC's corporate address in Johnson City.

Questions were initially raised by PEC's Chief Financial Officer following Mr. Fuelberg's departure from the Cooperative, and in response to a review of PEC bank accounts at Cattleman's. While it was generally known by some PEC personnel that Texland was a venture in which PEC had participated many years ago, the reasons for the continued existence of Texland as a corporate entity and of a Texland bank account were not known.

A preliminary investigation indicated that Messrs. Burnett and Fuelberg at one time were, and apparently continued to be, the authorized signatories on the account.[134] In addition, preliminary discussions with PEC personnel disclosed that PEC had been receiving monthly bank statements for the Texland account for many years, with a long-standing instruction from PEC management to forward the statements to Rory Boatright (most recently in the care of Jay Frazier at Moursund Insurance Agency), with a forwarding address the same as that of the Moursund Law Firm and other Moursund interests in Round Mountain, Texas. However, little was known about either the source of the funds in this account, PEC's continuing relationship to Texland, or why PEC was receiving bank statements for Texland that were subsequently forwarded to a third party.

B. Work Performed

In light of the questions raised regarding the funds in the Texland account, the scope of our efforts expanded to include the research and investigation of the historical relationship between PEC and Texland; the origination, purpose, and source of funds in the Texland account; why Texland and the

[132] Texland Electric Cooperative, Inc., Certificate and Articles of Incorporation, March 14, 1978.

[133] Cattleman's Bank Account statement for the period May 30 to June 30, 2008, Checking Balance $565,350.62.

[134] Texland Electric Cooperative, Inc. signature card for Cattleman's National Bank account number 01003194, November 1, 1986. Efforts by Pedernales Electric Cooperative, Inc. to verify the existing signatories on the account have not been successful as Cattleman's National Bank has sought adjudication of the ownership of the account through litigation.

account were still in existence; why the funds were held in a non-interest bearing account; and the extent of PEC's ownership and/or claim to the funds in that account.[135]

Initial efforts were focused on identifying information in PEC's possession relating to the Texland venture, including a search of PEC's electronic data management system (EDMS), a detailed search for historical accounting information, and discussions with various employees in PEC's Financial Department. After limited information was identified internally, the investigation expanded to encompass requests for information and assistance from various outside parties including Bluebonnet, LCRA, Clark Thomas & Winters, the Moursund Law Firm, Cattleman's, and the City of Johnson City.

In addition to the requests for information and assistance, informal discussions were held with current employees of Bluebonnet, current and former employees of LCRA, certain PEC Directors, and a former consultant involved in the Texland venture; all of these inquiries provided useful information and historical perspective in addressing the questions raised.[136]

At PEC's request, information in relation to Texland held in the files of Bluebonnet, Clark, Thomas & Winters, the Moursund Law Firm, and LCRA was made available to the investigative team. Such information included correspondence, various technical documents and reports in support of the proposed coal-fired generation plants, documents pertaining to Texland's efforts to gain regulatory approval for the proposed plants, as well as litigation-related efforts by PEC to be released from its existing wholesale power supply contract with LCRA, and certain financial information including a Texland check register for the Cattleman's account and bank statements evidencing the sources and uses of funds by Texland during its existence.

C. History of Texland

1. Background

Texland was incorporated on March 14, 1978 on behalf of PEC and Bluebonnet by W.W. Burnett, G. H. Klossner and A. W. Moursund.[137] Texland was created for the purpose of generating and furnishing "wholesale electric energy to electric distribution cooperatives at the lowest cost…"[138] Pursuant to the Texland bylaws, Texland was open to electric cooperatives that desired membership and agreed to abide by the terms set out in the Texland bylaws. PEC and Bluebonnet reportedly

135 At the request of the Texas Department of Public Safety, the identified Texland account was placed in "suspense status" by Cattleman's National Bank pending the resolution of these questions by the parties involved. (Cattleman's National Bank Letter to Pedernales Electric Cooperative, Inc. and Bluebonnet, dated August 8, 2008).

136 Brief discussions were held with representatives of Cattleman's National Bank who, because of asserted concerns over disclosing confidential information regarding an account at the bank, were unwilling to provide significant information.

137 Texland Electric Cooperative, Inc., Certificate and Articles of Incorporation, March 14, 1978.

138 Texland Electric Cooperative, Inc. Bylaws, adopted by the Incorporators on February 14, 1978 and by the Directors of Texland on June 7, 1979.

were the incorporating and sole members of Texland, with PEC holding a described 68% ownership and Bluebonnet the remaining 32%.

A second Texland entity, Texland Electric Company, was created on February 8, 1982, for the purpose of generating and distributing electric energy.[139] This second Texland company was wholly owned by the Texland cooperative and had the same officers and Directors as the Texland cooperative.

As described in documents and interviews, PEC and Bluebonnet wanted to build their own generation facility to meet significant forecasted load growth and eventually to part ways with LCRA as their wholesale supplier. The proposed facilities consisted of three 500-Megawatt mine-mouth lignite-fired plants--Texland 1, 2, and 3--to be built consecutively. In support of its efforts, Texland entered into various contracts including a contract with Shell Oil Co. ("Shell") for a source of coal (i.e., lignite) and Houston Lighting and Power ("HL&P"), which agreed to purchase excess generation not initially needed by PEC and Bluebonnet (or other cooperatives that might become members of Texland).

In 1981, Texland, PEC, and Bluebonnet filed an application with the Public Utility Commission for a generation Certificate of Convenience and Necessity ("CCN") seeking regulatory approval for the Texland plants (Docket No. 3896).[140] However, in the previous month, the LCRA had filed an application for a generation CCN for a coal-fired plant to be built in Fayette County, Texas (i.e., Fayette 3) (Docket No. 3838).[141] The Public Utility Commission apparently treated these filings as competing applications and the dockets were initially consolidated for hearing and decision. In 1982, the Public Utility Commission granted LCRA's application and remanded Texland's for additional hearing on its financing plan and on issues related to management, operating, and construction expertise. The Public Utility Commission denied Texland's application in April, 1983.

Texland, PEC and Bluebonnet appealed the Public Utility Commission's decision. The district court reversed the decision in September, 1983.[142] However, the Austin Third Court of Appeals upheld the Public Utility Commission order in December 1985.[143] Texland, PEC and Bluebonnet also filed antitrust litigation against LCRA that was pending through 1987 when the parties reached an agreement to settle.[144] The settlement dismissed all litigation and resulted in the 1987 amendment to the Wholesale Power Agreements between LCRA and PEC and Bluebonnet, respectively, that extended the two distribution cooperatives' existing contracts with LCRA to 2016 (these contracts, with various amendments, were still in force until recently).[145] In addition, on the same day as the amendment to the respective Wholesale Power Agreements, LCRA paid Texland $18,063,110.90,

[139] Texland Electric Cooperative, Inc., Articles of Incorporation, February 8, 1982.
[140] At a later date, Texland Electric Co. was substituted on the application for Texland Electric Cooperative, Inc.
[141] Supplemental Examiner's Report (PUC), Docket #3986, dated April 1, 1983.
[142] Plaintiff's Trial Brief, dated September 9, 1983.
[143] Third Court of Appeals, Opinion No. 14391; PUC v. Texland, 12/11/1985.
[144] Civil Acton No. A-82-CA-469, Texland v. LCRA.
[145] Memorandum of Agreement, September 11, 1985.

effectively constituting reimbursement of Texland's expenses incurred during development of the aborted generation project.[146]

As of a few months prior to issuance of this Report, both Texland entities were still in existence according to the Secretary of State's records. In addition, primarily at Mr. Fuelberg's direction, PEC had continued to file franchise tax forms with the State of Texas on behalf of both entities in order to maintain their corporate existences.

2. Texland Officers and Board of Directors

The registered agent listed with the Texas Secretary of State for both Texland entities at the time of the investigation was W.W. Burnett. The Board of Directors for Texland initially consisted of representatives from both PEC and Bluebonnet, with Bennie Fuelberg, W.W. Burnett and M.C. Winters initially representing PEC and Henry Umscheid, Robert E. Brown and Charles Machemehl representing Bluebonnet.[147] Mr. Fuelberg was also described as the General Manager of Texland. The officers of Texland, as described in filings with the Texas Secretary of State over the past few years, were Rory Boatright (Controller), Robert Brown (Vice-President) W.W. Burnett (President) and Charles Machemehl (Secretary/Treasurer). The same officers were also listed for Texland Electric Co. It should be noted that both Robert Brown and Charles Machemehl have been deceased for a number of years.

In addition, Rory Boatright, most recently listed as Controller of Texland and to whom the Texland bank statements sent to PEC were forwarded, was at the time of the investigation a Director of Cattleman's National Bank and a registered agent and listed officer for various entities controlled by the Moursund family.

3. Rockdale Power Project

The proposed coal-fired electricity generation plants central to the Texland project were to be constructed near the city of Rockdale in Milam County, Texas. These facilities were originally envisioned to be financed through bonds issued by Texland Electric Company, but the financing plan was thereafter modified to provide for the proposed issuance of up to $2.39 billion in municipal bonds by the City of Johnson City, Texas and the City of Caldwell, Texas.[148] The proposed project, for purposes of these financings, was described as the "Rockdale Power Project."

4. Texland Financing

The Texland venture was initially funded through $6.8 million in loans from the National Rural Utilities Cooperative Finance Corporation ("CFC"). The loans were essentially guaranteed by PEC

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[146] Receipt of funds document, signed by Texland Electric Cooperative, Inc., Bluebonnet Electric Cooperative, Inc. , and Pedernales Electric Cooperative, Inc., May 26, 1987.

[147] Mr. Umscheid was the General Manager of Bluebonnet Electric Cooperative at the time and Messrs. Brown and Machemehl reportedly were Directors of Bluebonnet.

[148] Preliminary Official Statement, December 1985 (Draft), Central Texas Public Power Finance Corporation, $2,390,000,000 Rockdale Power Project, Variable/Fixed Rate Power Supply Revenue Bonds.

and Bluebonnet, at 68% and 32% shares respectively, consistent with their agreed ownership share in Texland.[149] The remaining operating funds required by Texland were advanced/loaned to Texland by PEC and Bluebonnet over the years. While it is our understanding that PEC and Bluebonnet initially agreed to split the costs incurred on behalf of Texland 68% to 32%, as the expenditures related to Texland mounted over the years of the project's development, Bluebonnet's interest in the project reportedly waned, and PEC ultimately covered a larger portion of Texland's expenses than was originally conceived.

5. Texland Expenditures

In preparation for both the building and financing of the lignite-fired generation plants, Texland incurred and expended significant sums to various consultants, attorneys and contractors (e.g., Burns & McDonnell, Basic Resources, Clark, Thomas, Winters & Newton, etc.). In support of its efforts, Texland also entered into a $2,000,000 contract with Shell in May, 1980 to secure a source of lignite for the proposed plants.[150] In addition, Shearson Lehman Brothers ("Shearson Lehman") provided substantive support in preparation for the bond offering once Texland received the go-ahead for the construction of the plants. Prior to the settlement with LCRA and the parties' agreement to forego the planned Texland generation project, Texland, PEC and Bluebonnet had incurred in excess of $18 million in consulting fees, interest and other expenses in connection with that effort.

6. Settlement Agreement

After protracted proceedings, PEC, Bluebonnet and LCRA reached an agreement in September 1985 settling the outstanding lawsuits between the parties.[151] However, the appeal of the Public Utility Commission's rejection of Texland's application for construction of the coal-fired generation plants was ultimately denied in December 1985.[152] In July 1986, LCRA made offers to PEC and Bluebonnet to settle any outstanding differences between the parties.[153] Primarily in exchange for an agreement by PEC and Bluebonnet to extend their existing wholesale power contracts, LCRA agreed to compensate PEC and Bluebonnet for their expenditures in connection with the Texland project. These agreements were of significant benefit to LCRA because PEC and Bluebonnet were its two largest wholesale customers and their contracts provided substantial revenue support for LCRA's own generation program.

[149] Letter from Ira Shesser, Loan Officer, National Rural Utilities Cooperative Finance Corporation to Bennie R. Fuelberg, December 21, 1979.

[150] Contract for Sale and Purchase of Lignite between Shell Oil Company and Texland Electric Cooperative, Inc., May 30, 1980.

[151] Memorandum of Agreement between Pedernales Electric Cooperative, Inc., Bluebonnet, Texland, the City of Johnson City, and LCRA, September 11, 1985.

[152] Texas Court of Appeals, Austin; Public Utility Commission of Texas, et al. v. Texland Electric Co., et al. No. 14391, December 11, 1985.

[153] Letters from S. David Freeman, General Manager of LCRA to Bennie Fuelberg and Henry Umsheid, General Managers of Pedernales Electric Cooperative, Inc. and Bluebonnet, July 22, 1986.

Both PEC and Bluebonnet agreed to the settlement with LCRA in March 1987 by executing the separate settlement offers sent to them by LCRA on July 22, 1986.[154] The Bluebonnet agreement was executed by Sid B. Stevenson on March 10, 1987. The PEC agreement was executed by W.W. Burnett on March 17, 1987. Notably, and primarily due to Bluebonnet's efforts to re-draft the terms of the July 22, 1986 letter, the respective agreements between each of the parties with LCRA were somewhat different. With regard to PEC, LCRA agreed to:

> *"…compensate Pedernales for its expenditures in connection with its Milam County Generation Project, and it is mutually agreed that such amount is estimated to be at least $13,000,000. Pedernales agrees to transfer to LCRA all studies, research, environmental work and other assets associated with this project it may legally transfer without approval of third parties."*

However, with regard to Bluebonnet, LCRA agreed to:

> *"… purchase from Bluebonnet the lignite resource investment of Bluebonnet in Milam County, Texas, and related assets at a fair price that is mutually agreed upon."*

The final agreed settlement amount totaled $18,063,110.91, which was paid to Texland by LCRA with a check dated May 26, 1987.[155] The $18 million included a reimbursement of various expenditures incurred by Texland, as well as by PEC and Bluebonnet, including interest on loans by each to Texland over the years. The reimbursement also covered certain accrued expenses or outstanding liabilities of Texland that had yet to be paid as of the settlement date. A summary of Texland's total expenditures and accrued expenses as of May 1987 is provided below:[156]

Description	**Amount**
Interest Paid and Accrued	$7,645,390
Engineering Services	4,759,328
Deposit with Shell for Lignite Reserves	2,000,000
Legal Services	1,944,514
Environmental Services	746,675
Expert Witness Services	546,147
Administrative and General Costs	445,458
Less: Interest Earned	(7,464)
Less: Audit Adjustment to Certain Invoices	(16,937)
Total Expenditures and Accrued Expenses	**$18,063,111**

During the relevant time period, Texland had two successive bank operating accounts. Texland's initial bank account was with the Johnson City Bank from 1980 through October 1986. In October 1986, Texland opened an account with Cattleman's and subsequently closed its Johnson City Bank account. During the course of our investigation, bank statements for each account were identified

[154] The document is actually dated March 10, 1986 but other information supports the date as 1987 (especially given that the July 22, 1986 letter from LCRA had not been sent to Bluebonnet by that time).

[155] LCRA Check # 258486 payable to Texland Electric Cooperative, Inc., May 26, 1987.

[156] Texland Electric Cooperative, Inc. Expenditures and Accrued Expenses, May 18, 1987.

and analyzed.[157] A summary of the total sources and uses of funds for Texland from 1980 through December 1991 (through both operating accounts) is provided in Exhibit 4.

7. Use of the Settlement Proceeds

Upon receipt, the settlement funds from LCRA were allocated as follows:

Entity		Amount Paid
Pedernales		$12,903,126.74
Bluebonnet		$3,754,759.71
Texland		$1,405,224.46
		$18,063,110.91

Records indicate that Bluebonnet and PEC were paid by Texland through wire/bank transfer on May 27, 1987 with Bluebonnet receiving $3,754,759.71 and PEC receiving a deposit of $12,903,126.74.[158] The remaining $1,405,224.46 was deposited into Texland's Cattleman's bank account for payment of outstanding liabilities. The amounts received by Bluebonnet and PEC were to reimburse each for their respective portions of the guaranteed $6.8 million loan Texland received from CFC, cash advances by each, accrued interest, and certain expenses incurred by the parties.

Based on the records identified during the investigation, it appears that both Bluebonnet and PEC were fully reimbursed for the costs incurred by each in relation to the Texland venture. Bluebonnet appears to agree with this assessment, and PEC accounting records reflect a total return of PEC's investment, which is described in more detail below. A reconciliation of the use of the settlement proceeds, including Texland's payment of its outstanding liabilities, is attached as Exhibit 5.

8. Shell Contract and Refund

While the $18 million paid pursuant to the Settlement Agreement with LCRA was intended to compensate PEC, Bluebonnet, and Texland for all of the Texland project expenditures incurred, Texland continued to have certain unresolved claims and obligations after the settlement with LCRA. Included in these was a recovery or refund from Shell in relation to the $2,000,000 contract executed in 1980 relating to Shell's lignite reserves in Milam County.

The contract between Texland and Shell was executed on May 30, 1980 with a $2,000,000 payment to Shell. The contract provided Texland with a source of lignite as fuel for the proposed lignite-fired generation plants. The $2,000,000 payment was structured as a deposit against future deliveries of lignite once the electricity generation plants were operational. In the event this did not happen, the contract also provided for the potential refund of the $2,000,000 with interest if either party cancelled

157 We also identified a bank account for Texland Electric Company at Johnson City Bank that was opened on February 25, 1982 with a $1,000 initial deposit. We noted no activity in the account other than a deposit of $158 on July 26, 1983 until that account was closed on September 15, 1993 and the balance of $1,158 was transferred to Texland's Cattleman's account.

158 Deposit slips: The First National Bank, deposited by Bluebonnet Electric Coop General Fund, May 27, 1987; and Texas Commerce Bank, deposited by Pedernales Electric Cooperative, Inc., May 27, 1987.

the contract for various reasons including "Texland's failure to obtain the permits necessary for its performance…"[159]

Subsequent to Texland's failure to gain regulatory approval for the proposed plants and the settlement with LCRA, Texland pursued a return of the $2,000,000, plus interest from Shell. A draft letter from Texland to Shell terminating the contract between the parties was developed within days of receipt of the payment in the settlement from LCRA on May 26, 1987, and presumably sent to Shell sometime thereafter.[160] On October 1, 1987 Texland received the refund of the $2,000,000 from Shell plus $1,509,997 in interest.[161]

9. Return of CFC Patronage Capital

In addition to the funds received from Shell, Texland also received various payments from CFC in return of certain patronage capital accumulated by CFC during the period 1981 – 1985. Any net income realized by CFC, as a cooperative with non-profit status, during a given year was subject to rebate to CFC borrowers. Pursuant to its rebate policies, CFC subsequently returned to Texland a certain portion of the CFC net margins for the years during which Texland's $6.8 million loan was outstanding with CFC (i.e., 1981 – 1985). In total, Texland received $347,382 in a return of patronage capital from CFC. The payments were received by Texland during the period 1987 – 1991. More specifically, the payments received by Texland included the following:[162]

Patronage Capital Refund from CFC for:	Date Received	Amount
1981	6/19/87	$42,391.00
1982	6/10/88	$96,054.00
1983	6/22/89	$98,726.00
1984	8/10/90	$52,190.86
1985	8/6/91	$58,020.24
		$347,382.10

10. Use of the Shell Contract Refund and CFC Return of Patronage Capital

The $3,509,997 received from Shell was deposited into Texland's Cattleman's bank account on October 1, 1987. On that same day, a check was written to Shearson Lehman in the amount of $1,250,000 and another check for $150,000 to A.W. Moursund. Both checks were signed jointly by Messrs. Burnett and Fuelberg.[163]

Prior to the finalization of the parties' settlement with LCRA, Shearson Lehman had approached Mr. Fuelberg requesting that consideration be paid to Shearson Lehman for the various services the firm had provided in connection with the proposed bond offering. Among the services cited by Shearson

[159] Contract for Sale and Purchase of Lignite between Shell Oil Company and Texland Electric Cooperative, Inc., May 30, 1980.
[160] Draft letter from W.W. Burnett to Shell Oil Mining Company, Attn: Mining Department, drafted May 28, 1987.
[161] Deposit ticket for Texland Electric Cooperative, Inc. in the amount of $3,509,997.01, October 1, 1987.
[162] Various CFC statements and deposit tickets.
[163] Texland Electric Cooperative, Inc. check numbers 0146 and 0147, Cattleman's National Bank Acct. # 01003194.

Lehman, in addition to developing the financing plan, were assisting with the settlement negotiations with LCRA, obtaining guaranteed investment contracts, and completing an extensive bond marketing effort.[164] Shearson Lehman had negotiated that its fees were to be paid out of the proceeds from the anticipated bond offering. However, the regulatory denial of Texland's CCN application and the settlement with LCRA foreclosed that possibility.

In essence, PEC, Bluebonnet and Texland were to be made whole as a result of the settlement, yet Shearson Lehman stood to incur not only the loss of its expected fees based on the bond proceeds, but also its out-of-pocket costs paid for managing the development of the bond offering memorandum. To recoup a portion of these losses, Shearson Lehman requested a payment of $2,782,762, which consisted of reimbursement for $1,282,762 in various out-of-pocket costs and $1,500,000 in professional fees for its services.[165]

By resolution dated September 21, 1987, the Board of Directors of PEC authorized the officers and Directors of Texland "…to pay the compromise settlement of $1,297,000; or such lesser amount as can be agreed upon with Shearson…out of the money to be paid to Texland Electric Cooperative, Inc. by Shell Mining Company."[166] We discovered no information that shed light on the issue of whether such a payment was agreed to by the Texland Board of Directors and the representatives of Bluebonnet.

11. Return of Partial Refund to Bluebonnet

Bluebonnet received, as its portion of the Shell refund, a check from Texland dated April 25, 1988 for $1,166,196.03.[167] The amount was derived based on Bluebonnet's 32% share of the $3,509,997 Shell refund (based on Bluebonnet's 32% share in Texland) plus $42,996.99 in interest from the date the check was received by Texland on October 1, 1987 until April 25, 1988. The reason why Bluebonnet did not receive payment for almost eight months is not known.

12. Return of Partial Refund to PEC

With regard to PEC, the remaining funds from the Shell refund, in addition to the patronage capital refunds, were used to pay certain small additional expenditures, as well as to make payments to Messrs. Fuelberg and Burnett. Messrs. Fuelberg and Burnett were each paid $111,600 by checks dated February 29, 1988 written on the Cattleman's account.[168] A described "partial liquidation payment" was also made from the account to PEC on December 28, 1990 in the amount of $500,000.[169] The payment was recorded by PEC in satisfaction of $46,562.19 in outstanding liabilities from

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[164] Letter from Jerry S. Pierce, Shearson Lehman Brothers, to Bennie Fuelberg, Re: Investment Banking Financial Advisory Services in Connection with the Rockdale Power Project, March 26, 1987.
[165] Letter from Jerry S. Pierce, Shearson Lehman Brothers, to Bennie Fuelberg, Re: Investment Banking Financial Advisory Services in Connection with the Rockdale Power Project, March 26, 1987.
[166] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., September 21, 1987.
[167] Texland Electric Cooperative, Inc., check number 0153, Cattleman's National Bank Acct. # 01003194.
[168] Texland Electric Cooperative, Inc., check numbers 0150 and 0151, Cattleman's National Bank Acct. # 01003194.
[169] Pedernales Electric Cooperative, Inc. General Ledger Entry "Partial liquidation for Texland," December 31, 1990.

Texland for invoices paid by PEC on Texland's behalf, with the remaining $453,437.81 booked to *Miscellaneous Non-Operating Income*.

The funds remaining on deposit in the Texland account at Cattleman's National Bank that were identified during the investigation are the proceeds remaining from the Shell refund of $565,310, plus several small payments subsequently returned to Texland by Bluebonnet as capital credits in relation to an electric meter maintained for Texland as a Bluebonnet member at the site of the proposed electric generation plants.

A schedule summarizing the use of the proceeds of the Shell contract refund and the return of patronage capital from CFC is provided as Exhibit 6.

D. Observations and Findings

1. Control of Texland

While it appears that the Texland venture began as a true cooperative effort between PEC and Bluebonnet, over the years and with the increasing strain of the Texland expenses, PEC increasingly controlled Texland, the regulatory proceedings, the litigation, and the project finances, to an even greater degree than indicated by PEC's majority interest in the entity. For example, by the 1987 settlement date, PEC appears to have significantly controlled the bank account at Cattleman's and the financing of Texland, with Messrs. Burnett and Fuelberg being the only authorized signatories on checks written on behalf of Texland for the account.

2. Payments to Moursund, Fuelberg and Burnett

As described above, Messrs. Moursund, Fuelberg and Burnett each received a substantial sum from the refund on the Shell contract with Mr. A.W. Moursund receiving $150,000 the same day as the Shell refund and Messrs. Fuelberg and Burnett receiving $111,600 each in April 1988. These payments were described in a recent letter received by PEC from Messrs. Fuelberg and Burnett as compensation for their "efforts on behalf of Texland over the course of the nearly decade-long litigation."[170] The letter went on to describe the payments as "…earned for years of hard but ultimately successful efforts on behalf of Texland."[171] A memorandum written by A.W. Moursund as an attachment to his fee statement describes the services he provided in conjunction with the Texland venture and his negotiations with Shearson Lehman as consideration for his $150,000 payment.[172] However, the referenced payments were not the only payments received by the individuals from Texland over the years.

Judge A.W. Moursund received approximately $6,000/month as a retainer for his efforts on behalf of Texland starting in 1980, with the last payment in 1987. A.W. Moursund, indirectly through the

[170] Letter from Bennie Fuelberg and W.W. Burnett to Juan Garza, Re: Texland Electric Cooperative, Inc., August 20, 2008.

[171] Letter from Bennie Fuelberg and W.W. Burnett to Juan Garza, Re: Texland Electric Cooperative, Inc., August 20, 2008.

[172] "Background Memorandum to Statement" of A.W. Moursund, October 1, 1987.

Moursund Law Firm and the Moursund Insurance Agency also received additional sums totaling $58,063. In total, Mr. Moursund received approximately $783,746 in payments from Texland, including reimbursements for certain expenses. During the course of the investigation, we were unable to locate any detailed support for the legal or insurance-related services provided by the Moursund Law Firm and insurance agency.

At least from 1980 through July 1984, Judge Moursund appears to have been compensated both as the full-time General Counsel (and employee) of PEC and through a $6,000 per month retainer fee from Texland. Judge Moursund's total compensation from PEC and Texland during this period was approximately $539,476. However, in July 1984 Judge Moursund retired from PEC as an employee and started to receive a monthly retainer of $5,812 from PEC for continued service as General Counsel. From July 1984 through October 1, 1987, the date of the last payment received by Judge Moursund from Texland, he was paid an additional $812,248 in total retainer fees from PEC and Texland.

We are not aware of any changes in Judge Moursund's responsibilities to the Cooperative after he ceased being an employee and began working on a contract basis in 1984. Judge Moursund's change in employment status appears to have been related to issues that arose in connection with an application for a rate increase before the Public Utility Commission in 1983.[173] The Director of Accounting for the Public Utility Commission at the time raised concerns regarding perceived conflicts of interest involving Judge Moursund as a full-time employee of the Cooperative and his work on a retainer basis for Texland, as well as other work involving PEC and the Moursund Insurance Agency and Moursund Abstract Title Company. The dispute appears to have resulted in an agreement between the Public Utility Commission and the Cooperative regarding PEC related party transactions and contract bid procedures, which likely led to the change in Judge Moursund's employment status.[174] Judge Moursund's relationship with PEC over the years is addressed in more detail in a subsequent section of this Report.

The total fees received by Judge Moursund and various Moursund-related entities during Texland's existence were approximately $1,409,787. A schedule summarizing the total retainer, salary and other payments received by Judge Moursund and certain Moursund-related entities is provided in Exhibit 7.

Messrs. Fuelberg and Burnett also received additional sums from Texland, described as per diem payments in relation to their efforts with Texland and the Texland Board of Directors. Bluebonnet representatives on the Texland Board of Directors also received similar payments. The payments to Messrs. Fuelberg and Burnett totaled $11,175 and $9,422, respectively, over the period 1980 – 1982. No additional payments were identified between the last payment in 1982 and the $111,600 payments received in early 1988.

[173] Direct Testimony of Billy G. McEuen, Accounting Division, Public Utility Commission of Texas, Re: Application of Pedernales Electric Cooperative, Inc., for a Rate Increase, Docket No. 5109, June 1983.

[174] Agreement, Docket 5109.

The Texland bylaws allowed Directors a "…reasonable per diem sum and all expenses for their attendance at…such other meetings as any member of the Board of Directors may be directed by the Board of Directors to attend."[175] While the Texland Directors presumably participated in numerous meetings in relation to the Texland venture, Navigant Consulting was unable to identify Board of Director Meeting Minutes for any Texland Board meetings. In addition, we did not identify any reference in the PEC Board minutes either authorizing or disclosing such payments to PEC representatives on the Texland Board.

3. Board Lack of Knowledge/Approval of Payments

Interviews of Directors seated on PEC's Board at the time of the Texland venture reflect their reservations about Texland and their concerns with the level of disclosure with respect to the amount of money being invested in Texland. The PEC Board minutes reflect little to ascertain how much was being loaned to, and expended by, Texland or for what purpose.

Discussions with PEC Board members whose tenure paralleled the Texland venture and the years thereafter also indicate that they were not aware of the dollar amounts refunded by Shell or that CFC had been returning patronage capital on the Texland loans. In addition, these Directors have no recollection of any discussion regarding Texland-related payments being made to Messrs. Fuelberg and Burnett. Many of these Directors expressed their surprise and concern that such payments were made, that the payments had been made without their knowledge, and that a bank account in Texland's name containing a sizeable balance had been maintained for nearly two decades without their knowledge.

Messrs. Fuelberg and Burnett assert in their recent letter to PEC that the payments were disclosed to PEC.[176] However, there is no evidence in the PEC Board minutes during the years in question that the $111,600 in payments (nor the $150,000 payment to A.W. Moursund) were authorized, approved or even disclosed. In addition, there is no reference in the PEC Board minutes to the amount refunded on the Shell contract, the fact that PEC had received patronage capital refunds from CFC in each of five years beginning in 1987, that a $500,000 payment was made as a return of capital to PEC, the $565,000 in funds remaining in a Cattleman's bank account, or the fact that these funds were held in a non-interest-bearing checking account for two decades. In fact, there is no reference to Texland in the PEC Board minutes at all after the September 1987 PEC Board meeting at which the proposed payment to Shearson Lehman was discussed.

4. Bluebonnet's and PEC's Respective Share of Costs.

It is important to note that Bluebonnet's share of funds ultimately allocated to it at the termination of the Texland venture in 1988 was based on the entire refund received from Shell, without regard to the $1,250,000 paid to Shearson Lehman. Discussions with Bluebonnet representatives and a review of

[175] Texland Electric Cooperative, Inc. Bylaws, adopted by the Incorporators on February 14, 1978, and by the Directors of Texland on June 7, 1979.

[176] Letter from Bennie Fuelberg and W.W. Burnett to Juan Garza, Re: Texland Electric Cooperative, Inc., August 20, 2008.

various documents available lead us to believe that Bluebonnet was unaware of the return of the Shell refund until some time in early 1988. In addition, we are not aware of any additional payments to Bluebonnet arising out of the return of patronage capital from CFC. Assuming that both PEC and Bluebonnet should have borne the costs and benefited in the refunds in proportion to the 68%/32% ownership interest in Texland, Bluebonnet benefited by an amount in excess of $332,000. Whether the amounts divided between PEC and Bluebonnet were negotiated and agreed to by the parties was not determined by the investigation. A schedule summarizing the estimated share of the respective proceeds and costs of Texland between PEC and Bluebonnet subsequent to the executed Settlement Agreement in May 1987 is provided in Exhibit 8.

5. Loss of Value – Non-Interest Bearing Account

As stated, the funds deposited at Cattleman's were in a non-interest bearing checking account. The account was initially opened in October, 1986 and became the main operating account for Texland after the closure of Texland's prior operating account at Johnson City Bank the same month. Even at a long-term risk free rate of interest of 3%, the balance in the account could have grown by almost $400,000 since 1991 if it had been in an interest-bearing account.[177] If the funds had been reinvested back into PEC, at an estimated cost of capital of 6%, the funds would have returned significant benefit to PEC, which would have equated to over $1 million in interest.

6. Questionable Relationship with Cattleman's National Bank

Cattleman's was established in June, 1986.[178] As described, Texland opened its bank account at Cattleman's several months later in October, 1986. It is not known why Texland moved its account from Johnson City Bank to Cattleman's. However, in addition to Cattleman's being owned in large part by the Moursund family, we are aware that other Directors of PEC at the time were approached about investing and at least two Directors at the time appear to have made relatively small investments in the start-up of Cattleman's. It is not known whether Messrs. Fuelberg or Burnett, or any other members of Bluebonnet or PEC's Board, had an ownership interest in Cattleman's, or to what extent.

As a lightly capitalized start-up bank in June 1986, Cattleman's can be said to have received a significant benefit, especially in its early years of operation, from the deposit of the funds arising from the Shell refund in 1987 and the continuing balance in the Texland account over the ensuing two decades. It is reasonable to assume that the officers, and perhaps even the Directors, of Texland were aware of this benefit given the size of Texland's account relative to any other non-interest bearing accounts held at Cattleman's during the same period.[179]

In addition to the Moursund ownership and control of Cattleman's, other PEC members also served on the Board of Cattleman's at various points in time. Mr. Fuelberg appears to have been an

[177] The calculation of potential interest that could have been earned on the remaining Texland funds was made as of 1991, the point after which no additional funds were received or disbursed from the account.
[178] Federal Deposit Insurance Corporation, Individual Bank Information, Cattleman's National Bank.
[179] Federal Deposit Insurance Corporation, Federal Financial Reports, Cattleman's National Bank, 1986 - 2007.

Advisory Director on the Cattleman's Board since the bank was established, as was Mr. Melvin C. Winters, a Director with PEC from 1987 until his death in 1991. Mr. Val Smith served on the Board of Directors of Cattleman's from its formation until recently. In addition, Mr. R. B. Felps, PEC's current Board President, was serving on the Board of Directors at Cattleman's at the start of the investigation, and reportedly resigned in mid-2008, as did Mr. Val Smith.

Rory Boatright, a Moursund-related consultant and employee, the individual listed in Texas Secretary of State's records as the "Controller" of Texland at the time of the investigation, apparently maintained the accounting records for Texland during the 1980s, and appears to have continued to maintain the Texland records until recently, as the Texland Cattleman's bank statement were forwarded to Mr. Boatright each month. Mr. Boatright also was listed as a Director of Cattleman's.

With respect to the Texland Cattleman's account, serious questions about the potential for impropriety are raised by at least the following circumstances: (i), the decision by Texland officers to open an account at a start-up institution substantially owned and controlled by PEC's General Counsel (who was receiving close to $12,000 a month from PEC and Texland combined); (ii) ownership participation in that institution by at least certain PEC Board members, and possibly others; (iii) the fact of a Board member of Cattleman's also serving as the listed "Controller" of Texland; (iv) the continued maintenance of substantial Texland sums in a non-interest bearing account for over 20 years after the conclusion of all Texland activities; and (v) the lack of disclosure to and approval by the PEC Board of activities described above.

7. Ownership of Texland

During the tenure of Texland's protracted development and its regulatory and litigation proceedings, Texland described itself as being "created and wholly owned by" Bluebonnet and PEC.[180] Bluebonnet and PEC were also separately described as the "sole members" of Texland.[181] In addition, the actions of the participants involved in relation to the Shell refund and to the subsequent payment to Bluebonnet of its 32% interest in the settlement proceeds support the conclusion that PEC and Bluebonnet were the joint owners of Texland and were jointly entitled to any benefits accruing in relation to Texland's activities.

8. PEC Accounting for Investment in Texland

Once it is determined that the remaining funds in the Cattleman's account belong to PEC, a determination Navigant Consulting believes to be appropriate based on the evidence it has reviewed, the funds may not have been appropriately accounted for in PEC's books and records for over 20 years. In addition, the receipt of the $500,000 partial liquidation payment recorded as *Miscellaneous Non-Operating Income* in 1990 may also not have been appropriately accounted for by PEC. Upon resolution of the questions surrounding ownership of the funds, these questions will need to be addressed by PEC in conjunction with its outside independent auditors.

[180] Plaintiff's Trial Brief, Texland Electric Co., et. al. v. Public Utility Commission of Texas, Docket No. 350,043.

[181] Court of Appeals of Texas, Austin. Public Utility Commission of Texas, et al. v. Texland Electric Co., et al. No. 14391, December 11, 1985.

9. Duties of Management – Failure to Inquire about Texland

The existence of Texland and the Texland bank account at Cattleman's for over 20 years raises serious questions as to management's and the Board's failure to inquire about matters relevant to the financial reporting of the Cooperative. The existence of Texland and the off-book funds (to the extent determined to be such) is another example of the control and oppressive management style exercised by Mr. Fuelberg in relation to the day-to-day operations of the Cooperative. The tone established by Mr. Fuelberg created an environment in which many managers were either unwilling to raise questions, or were quick to accept directives, on issues involving the financial and management operations of the Cooperative, including issues like the existence of Texland.

As described earlier in this Report, the Finance Manager was not delegated the authority that would be expected of a CFO or an entity's senior most financial person. Likewise, the Finance Department appears to have been limited to primarily an accounts processing and financial reporting function within the Cooperative, with lesser emphasis on internal controls, especially interdepartmental controls.

Limited evidence suggests that certain individuals may have raised questions regarding whether the relationship with Texland was being appropriately handled; however we have identified no evidence that those questions were ever raised with the Cooperative's outside auditors, or that any information with regard to Texland was ever shared with the Cooperative's outside auditors, at least during the period covered by the investigation. The oppressive management atmosphere at PEC, as previously described, appears to explain in large measure why such inquiries may not have been pursued.

It should be noted that the Cooperative's current Chief Financial Officer (CFO), Michael Vollmer, while serving in the role as Finance Manager for the Cooperative from October 2003 until earlier this year (when he was promoted to CFO), was responsible for filing the franchise tax forms and renewing the appropriate records with the Secretary of State to keep the entities active. While he was not an employee of the Cooperative in 1990, and likely had no reason to be aware of the $500,000 payment to PEC from Texland, he was aware of the monthly bank statements received in relation to Texland. In addressing this issue, Mr. Vollmer explained that he was following a procedure that had been adopted long before he was hired, that he was reassured by the former General Manager that the account was appropriately treated, and that in response to questions he raised about these matters he was instructed to continue that process.

E. Recommendations

Ownership of the Texland Funds

- Actions regarding the question as to ownership of the funds in the Texland account have already been taken by both Bluebonnet and PEC. Through a special meeting called by the Presidents of Bluebonnet and PEC, the essentially defunct Texland Board was reconstituted with three (3) representatives each from current Bluebonnet and PEC Board members.

- While an attempt was made to change the signatories on the Cattleman's bank account and proceed with a determination of the proper owner and disbursement of the remaining Texland funds, Cattleman's preempted this action by filing an interpleader action in the 424th Judicial District Court of Blanco County, seeking a judicial determination as to the ownership of the account proceeds.[182]

- A counterclaim, based on allegations of fiduciary obligation, was subsequently filed on behalf of Texland seeking damages from Cattleman's for lost interest on the balance in the Cattleman's account for the period the account has been in the bank's custody.

- Action is pending to transfer the funds in the Cattleman's bank into the custody of the court pending the outcome of the related court proceedings.

- In addition, discussions have also proceeded between the various parties (i.e., Texland, Bluebonnet, PEC and LCRA) regarding ownership of the funds in the Cattleman's account and whether the prior disbursements of funds in relation to the Shell contract refund and the patronage capital payments from CFC were properly allocated among the parties.

Accounting Treatment for the Texland Investment

- To the extent it is eventually determined that PEC has ownership of any portion of the remaining funds, PEC will need to evaluate the relative impact to its financial statements, and whether the Texland investment should have been reported on PEC's financial statements in the past.

- PEC, with the assistance of its independent outside auditors, will need to evaluate any potential failure to properly reflect its investment in Texland with respect to materiality, and whether PEC's historical financial statements properly reflect the financial condition of the Cooperative, in all material respects.

Policy Regarding Related Party Transactions

- In relation to Texland, as well as various related and affiliated party issues described throughout the Report, it recommended that the Board adopt a policy establishing specific authorization guidelines and disclosure requirements involving Cooperative transactions in which a related or affiliated party of either the Board, senior management or other PEC employee is involved. In addition, it is recommended that the Board consider establishing certain limits and/restrictions on related and affiliated party transactions going forward.

Internal Control Environment

- A significant concern arising from the Texland history is the apparent lack of inquiry from PEC officers, managers and financial department staff over the years in relation to why PEC was receiving a bank statement each month for Texland, and why the Cooperative was continuing to file required state franchise tax forms and maintain the Texland entities as

[182] Cattleman's National Bank v. Pedernales Electric Cooperative, Inc. et al., Cause No. CV 06636 in the 424th District Court of Blanco County, Texas.

active corporations when their apparent purpose had been concluded. It is recommended that PEC undertake to develop and implement control processes regarding the completion and submission of information related to filings with the Texas Secretary of State, including verification of the accuracy of such information, as well as establishing limits on the requisite level of authority and disclosures required for management and the Board.

- In addition, Navigant Consulting's recommendations related to the role of the Finance Manager and Finance Department, as well as their responsibilities regarding the Cooperative's overall control environment and control activities, are discussed in a previous section to the Report.

Evaluate the Propriety of Payments made to Messrs. Fuelberg, Burnett and Moursund

- Given the expressed concerns regarding the payments made to Messrs. Fuelberg, Burnett and Moursund from the Texland bank account, while each was effectively employed or retained to provide services to PEC, it is recommended that PEC evaluate the propriety of the payments, in relation to potential recourse for those payments.

XII. Envision Utility Software Corporation

A. Background

Envision Utility Software Corporation ("Envision") is a wholly owned subsidiary of PEC. Envision has developed, maintained and supported proprietary billing and customer information management software designed for the utility industry since its inception. Envision provides software development and support services to PEC associated with its foCIS customer information and billing system, which PEC uses in its business.

Envision is currently headquartered in Albuquerque, New Mexico, where Envision's software development team resides.[183] The company also maintains an administrative and customer support facility in San Marcos, Texas.[184] Envision employs 21 individuals at its headquarters in Albuquerque and has an additional 13 employees in its San Marcos data center. The company also employs two software developers who work remotely from their homes in Florida and New Jersey, respectively.

PEC began using Envision software in 1986 as a customer of Envision and eventually acquired the company in a series of three transactions between 1990 and 2002. Although a wholly-owned subsidiary of PEC since 2002, Envision has historically been maintained as a stand-alone entity governed by its own four-member Board of Directors. Since 1990, and until early 2008, that Board consisted of Messrs. Fuelberg and Burnett from PEC, and two outside Directors from Envision's prior owner, Cooperative Services, Inc. ("CSI").

Despite being organized as a for-profit subsidiary, almost all of Envision's business is derived from PEC. PEC currently funds substantially all of Envision's operating costs through a monthly capital call, with supplemental amounts as needed. A review of Envision and PEC records indicates that for the period 2002 – 2007, PEC has contributed approximately $30 million to fund Envision's operations.

Throughout the class action lawsuit, questions have been raised regarding the relationship between Envision and PEC; why substantial amounts are being paid to Envision each month; how that money is being used; and whether any of the funds have been misused or misappropriated to the detriment of PEC's members.

B. Work Performed

Navigant Consulting was retained to investigate the various allegations and questions raised regarding the Envision subsidiary, including a review of corporate expenditures by PEC in relation to Envision. In addition, Navigant Consulting was retained to provide certain business process improvement consulting services to PEC, including an evaluation of Envision's financial and

[183] The Albuquerque office was established in 2007 coinciding with the closure of the Santa Fe facility.

[184] The San Marcos location was established in 2005 and is located next door to the Pedernales Electric Cooperative, Inc. call center.

operational history and its relative importance to PEC. More specifically, the scope of Navigant Consulting's investigation and operational review of Envision was focused on the following:

- Developing an understanding of Envision's organizational structure, staffing and responsibilities, as well as its assets and liabilities.
- Determining the total cost and reasonableness of the Envision acquisition.
- Determining and evaluating the costs incurred/investment made by PEC in supporting Envision's ongoing operations, including the cost of service provided to PEC.
- Evaluating the ongoing operations of Envision, including the value of Envision to PEC, as well as opportunities for cost reduction, alternative means of maximizing the value of Envision and its products to PEC members, and the potential costs/benefits of merging Envision's functions into PEC.
- Determining the necessity of maintaining a separate Board and corporation.
- Reviewing historical expenditures in relation to the acquisitions as well as operating expenditures (e.g., travel and marketing costs) for potential misuse and/or misappropriation of corporate funds by Envision and/or PEC personnel involved with Envision.

In connection with our efforts, Navigant Consulting has conducted a detailed analysis of various aspects of Envision's business. The associated activities included:

- Reviewing and summarizing Envision's corporate history from inception through the present.
- Analyzing PEC's three purchases of Envision stock from Cooperative Services, Inc. ("CSI"), an association of rural utility providers, in 1990, 1995, and 2002, and the circumstances surrounding those transactions.
- Performing a high level analysis of the company's financial performance from 1986 through 2000, including reviewing historical sales, marketing, and operations activity.
- Preparing a detailed analysis of Envision's financial performance, transactions and expenditures from 2001 through 2007.
- Performing a functional review of the foCIS software and its use in the PEC call center, and evaluating the past and present relationships between Envision and PEC personnel.
- Comparing functional capabilities of foCIS to other leading software products, and assessing the competitive status of Envision relative to other leading software vendors.

- Interviewing key Envision and PEC personnel in relation to Envision's operations and accounting for those operations, capital calls and the capabilities of the foCIS system.
- Interviewing the two outside Directors of Envision: Malcolm Dalton and William Mershon.
- Touring the San Marcos, Texas and Albuquerque, New Mexico facilities and evaluating the foCIS and EnCode software and software development protocols; and
- Evaluating the historical cost and level of service provided to PEC with respect to the foCIS software, including a high-level comparison to the costs of competing products and vendors.

C. Limitations on Work Performed

Given the broad scope of our work related to Envision, requested information was not always available or reasonably accessible, especially with respect to our efforts to identify information in the earlier years under review. We were only successful in identifying limited detailed financial information for Envision prior to 2001. Various reasons were provided for the missing information including poor document organization and retention efforts, ineffective management and frequent management turnover, Envision's relocation efforts and a described loss/failure of Envision's Peachtree accounting system sometime in 2001. In addition, because of employee turnover and departures, we did not always find direct institutional knowledge with regard to certain transactions and issues being investigated. As a result, identifying certain hard copy and electronic information proved to be difficult. However, we believe that the information we received and reviewed was sufficient to accomplish the objectives of our investigation and business process evaluation.

D. History of Envision

1. PEC History as an Envision Customer

Envision was incorporated in New Mexico on January 23, 1986 to "develop and market computer systems to the utility industry."[185] Specifically, Envision was formed to market a software solution developed by CSI, an association of rural utility providers established in 1969 to provide data processing services to its various members through a shared services arrangement.[186] Envision was originally wholly-owned by CSI. In 1987, CSI's members consisted of eight (8) rural electric cooperatives in New Mexico, Arizona and Colorado, as well as the Navajo Tribal Utility Authority in Arizona.[187] Both CSI and Envision were originally headquartered in Santa Fe, New Mexico.

[185] Envision Utility Software Corporation, Certificate of Incorporation and Articles of Incorporation, January 23, 1986.

[186] Co-operative Services, Inc., Articles of Incorporation, July 1, 1969. CSI changed its name from "Co-Operative Services, Inc." to "Cooperative Services, Inc." on December 6, 1984 (see Articles of Amendment to the Co-Operative Services, Inc., Articles of Incorporation of, December 6, 1984).

[187] Cooperative Services, Inc./Envision Annual Report, 1987 - 1988. Note that the Navajo Tribal Utility Authority also operates in New Mexico and Utah.

Historically, CSI provided data processing services to its members through a timesharing arrangement.[188] The CSI software product consisted of a suite of applications that included consumer accounting (e.g., utility billing, capital credits), financial reporting and engineering components. In the mid-1980s, however, the company developed a plan to sell its software to a wider market, with the objective of stabilizing and reducing rates, and improving the service it was providing to the members of CSI.[189] This plan was launched with the formation of Envision. Envision's software product was first introduced to the public at the National Rural Electric Cooperative Association Annual Meeting and Expo in early March 1986.

PEC was Envision's first customer, and the first utility outside of CSI's membership to use Envision software. PEC initially contracted with Envision on October 31, 1986.[190] The installation was reportedly near completion by mid-1987.[191] However, additional sales for Envision proved more difficult to achieve. Between 1987 and 1989, Envision recognized $1.1 million of revenue and $2.2 million of expenses, resulting in a cumulative net margin of negative $1.1 million. Consequently, by the end of 1989, retained earnings for the entity reached a deficit of nearly $1.5 million.[192] As of 1990, Envision had a total of seven customers.[193]

2. PEC's First Investment in Envision: December 1990

In early October 1987, CSI invited PEC to become a member of CSI.[194] CSI hoped to recapitalize with an infusion of equity from PEC, as well as spread CSI's existing operating costs among a larger base of CSI members.[195] However, rather than join CSI, PEC ultimately expressed an interest in a direct investment in Envision.[196] In May 1989, the CSI Board approved a proposal to sell 20% of Envision to PEC for $200,000.[197]

By the end of 1989, the PEC Board approved a resolution to negotiate and purchase stock in Envision. Negotiations and due diligence continued through much of the following year with an agreement finalized on December 3, 1990.[198] The final agreement differed from that originally contemplated in

[188] Timesharing, in which multiple firms share time on a single computer, was a popular way to reduce data processing costs when computers were prohibitively expensive.

[189] OEM Business Plan, prepared for the Board of Directors of Cooperative Services, Inc., p. 3, August 9, 1985, and as revised June 26, 1986 and August 28, 1987.

[190] Board of Directors' Meeting Minutes for, Envision Utility Software Corporation, October 31, 1986.

[191] OEM Business Plan, prepared for the Board of Directors of Cooperative Services, Inc., p. 26-27, August 9, 1985, and as revised June 26, 1986 and August 28, 1987.

[192] Envision Utility Software Corporation Financial Statements, Years ended December 31, 1987 – 1989.

[193] Exhibit A to the Assignment and Assumption of Contracts Agreement By and Between Envision Utility Software Corporation and Envision Software Corporation.

[194] Letter from Eugene L. Cantu, General Manager of Cooperative Services, Inc., to Bennie R. Fuelberg, October 2, 1987.

[195] Cooperative Services, Inc. "Recapitalization Plan of 1987," October 28, 1987.

[196] Board of Directors' Meeting Minutes for Cooperative Services, Inc., December 6, 1988.

[197] Board of Directors' Meeting Minutes for Cooperative Services, Inc., September 27, 1989.

[198] Memorandum of Understanding, November 30, 1990 and Asset Purchase Agreement By and Among Envision Utility Software Corporation, Cooperative Services, Inc. and Envision Software Corporation, December 3, 1990.

CSI's May 1989 proposal. Rather than invest $200,000 for 20% of Envision, PEC paid $600,000 for a 50% interest in a newly created joint venture between CSI and PEC. The new entity was called Envision Software Corporation (the original name "Envision Utility Software Corporation" was ultimately adopted by the newly created entity in March 1992).[199] PEC's funds were used to purchase the assets of the existing Envision ($400,000) and for working capital ($200,000). The transaction is summarized in Exhibit 9.

At the time of PEC's investment, Envision was technically insolvent and was being supported primarily by debt. The book value of Envision's assets of $446,342 was significantly less than its liabilities of $2.08 million, and shareholder equity had fallen to a negative $1.63 million.[200] CSI was Envision's sole creditor, holding note and interest payables totaling over $1.8 million. Additionally, the withdrawal of two members from CSI reduced the operating leverage of the company and created additional rate pressure that would have been borne by the remaining members.[201]

While CSI's objective for entering into the agreement with PEC was primarily to provide additional capital to the struggling venture,[202] PEC's reasons were summarized by Mr. Fuelberg in a September 17, 1990 letter to PEC's Board of Directors and General Counsel, and included:[203]

- The quality of Envision's software which, "has functioned very well and provides the ability for our personnel to answer questions … quickly and accurately."
- History of good performance, "as evidenced by the lack of billing errors exhibited since we went to this program."
- Alternative systems "would be a step backwards in data processing" and require a large investment of time and capital.
- The probability of deterioration in the Envision software without an influx of funds to Envision "due to its declining financial condition."
- The ability to "exert more influence in setting the policies concerning software update and development as well as controlling other expenditures."

3. Envision Financial Performance: 1991 – 1994

Upon consummation of the sale, PEC took a leadership role in Envision with Messrs. Burnett and Fuelberg assuming the positions of Chairman and Vice Chairman, respectively, on the Envision Board of Directors.[204] The remainder of the four-person Board consisted of William F. Mershon, as Secretary, and Malcolm P. Dalton, as Treasurer. Mr. Mershon was General Manager of the Otero County Electric Cooperative in Cloudcroft, New Mexico and was President of the Board of CSI at the

[199] Resolution, Envision Software Corporation, Shareholders' Meeting, March 27, 1992; and Envision Utility Software Corporation Board of Director Meeting Minutes, February 28, 1992.

[200] Asset Purchase Agreement By and Among Envision Utility Software Corporation, Cooperative Services, Inc. and Envision Software Corporation, dated December 3, 1990, Schedules 1.2 and 2.2.

[201] Cooperative Services, Inc./Envision Utility Software Corporation Annual Report 1989 – 1990.

[202] Letter from Eugene Cantu to Bennie Fuelberg, May 5, 1989.

[203] Letter from Bennie Fuelberg to Directors and General Counsel, Re: Purchase of Envision Software, dated September 17, 1990.

[204] Board of Directors' Meeting Minutes for Envision Software Corporation, December 3, 1990.

time. Mr. Dalton was General Manager of the Navajo Tribal Utility Authority, on the Executive Committee of CSI's Board, and was Vice President of the Envision Board of Directors at the time.[205]

Following PEC's acquisition of 50% interest, while Envision added a few additional customers between 1991 and 1994, the company continued to struggle financially due to a number of factors including poor performance on installations, conversions and overall support services.[206] As shown in the table below, from 1991 through 1994, Envision posted an aggregate net loss of $620,832.[207]

Envision Financial Statements (1991 - 1994)					
	1991	1992	1993	1994	Total
Revenues	$2,549,619	$2,319,567	$2,359,262	$1,913,034	**$9,141,482**
Net Income	$108,286	($192,678)	$54,991	($591,431)	**($620,832)**
Retained Earnings	$104,987	($87,691)	($32,700)	($624,131)	

4. Re-write of the Envision Software

Envision's sales efforts were also hampered in the early 1990s by the loss of the software's underlying support system. The initial Envision software developed in the early 1980s was built on a Database Management System ("DBMS") called UserBase, a trademarked product originally developed by UserWare International.[208] However, in January 1992 the new owner of UserBase announced that UserBase would migrate to its proprietary DBMS , GemBase, and that UserBase would no longer be maintained as an offered product.[209]

Although initially considering transitioning its software to GemBase, Envision decided to evaluate its options with the goal of identifying the best long-term solution.[210] After evaluating seventeen different DBMS platforms over a two-year period, Envision selected the Oracle DBMS platform for the next version of its software in early 1994.[211]

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[205] Cooperative Services, Inc./Envision Utility Software Corporation Annual Report 1989 – 1990. Board of Directors' Meeting Minutes for Envision Software Corporation, June 30, 1989.

[206] Board of Directors' Meeting Minutes for Envision Software Corporation, June 26, 1992.

[207] Envision Software Corporation Financial Statements with Accompanying Information, Years Ended December 31, 1991, 1992, 1993 and 1994.

[208] UserWare went through a number of ownership changes in the 1980s - 1990s - first, purchased by Pioneer Computer Group, the developer of GemBase; sold to Burrows Corporation in 1990, and resold to Ross Systems the following year.

[209] Board of Directors' Meeting Minutes for Envision Software Corporation, January 24, 1992.

[210] Memorandum to Gene Cantu, President from Gary Thomson, Director, Corporate Services, Re: Userbase Annual Support Fees Position, January 28, 1993.

[211] Board of Directors' Meeting Minutes for Envision Software Corporation, February 15, 1994.

Transitioning from UserBase to Oracle was a substantial undertaking that required a major re-write of the Envision software. Initial analysis estimated that the expenditure required to accomplish the rewrite would be between two and four million dollars.[212]

5. PEC's Second Investment in Envision: April 1995

Envision's General Manager at the time, John Kernaghan, questioned the viability of re-writing the software to Oracle, given Envision's financial constraints and inability to fund the re-write.[213] In response to the funding challenges, Envision explored various alternatives including a merger with CSI and the possibility of having outside parties invest in Envision. However, PEC did not support any course of action that would dilute its ownership interest in Envision. In July 1994, PEC ultimately offered to fund the development itself in exchange for majority ownership in Envision, a proposal which Bennie Fuelberg explained to the CSI Board as follows:[214]

> *"[T]he problems facing Envision will require additional capital which will still not be available after a merger of the two companies...PEC must begin serious investigation of other alternatives including development of new software using internal resources.*
>
> *If [CSI agrees to sell half of its shares], PEC would begin immediately developing new software using both its resources and Envision's resources…we cannot make the required investment in software without a majority ownership of Envision."*

CSI approved the concept of the sale and by the end of August 1994, the due diligence process was underway. Despite a cautionary analysis by Deloitte & Touche noting the potential downside risks to PEC,[215] the agreement was finalized on April 5, 1995. PEC paid $300,000 for half of CSI's shares, with CSI agreeing to contribute $200,000 of the funds back to Envision to help support the development effort.[216] The transaction is summarized in Exhibit 10.

PEC and Envision also entered into a Software Development Agreement that gave PEC the intellectual property rights to the new software. In addition, upon completion of the software re-write, Envision agreed to purchase a license to market the software, with the price of the license to be set equal to PEC's capitalized development costs, which at the time were estimated to be approximately $1.25 million.[217]

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[212] Board of Directors' Meeting Minutes for Envision Software Corporation, April 13, 1994.

[213] Letter from John J. Kernaghan, General Manager of Envision Utility Software Corporation, to Bennie Fuelberg, May 27, 1994.

[214] Letters from Bennie Fuelberg and W.W. Burnett, President to the Directors of Cooperative Services, Inc., July 20, 1994.

[215] Handwritten report from Larry Jones, Deloitte & Touche, September 26, 1994. According to a fax cover sheet, the document was reviewed by B. Fuelberg then faxed to W.W. Burnett on September 26, 1994.

[216] Stock Purchase Agreement between Cooperative Services, Inc., Pedernales Electric Cooperative, Inc. and Envision Utility Software Corporation, April 5, 1995.

[217] Software Development Agreement between Pedernales Electric Cooperative, Inc. and Envision Utility Software Corporation, April 5, 1995.

While PEC committed to investing $1.25 million in the project, the ultimate cost was many times higher. By the time the development effort was completed three years later, the capitalized portion of the development costs were estimated to exceed $5.67 million.[218]

6. Envision Financial Performance: 1995 – 2001

Following PEC's second investment in 1995, the primary focus of Envision became the development of the Oracle-based software package. Marketing and sales efforts were essentially put on hold until the completion of the effort. The software re-write effort was initially expected to last less than a year, however it would be almost three years before the new system was realized.[219] It appears that the new billing system, called the Customer Information Management System, or "CIMS," was rolled out beginning in September 1997.[220]

Envision's development team ran into various challenges including the complexity of the system conversion, as well as problems with outside contractors hired to assist in the re-write. Envision ultimately ended up hiring a number of the developer's employees who had been involved in the effort and establishing an office in St. Petersburg, Florida for them.[221]

Even after the software rewrite was completed, issues remained. A number of customers simply did not need, nor want to pay for, the powerful new CIMS software. Other than PEC, Envision's software users were small cooperatives averaging 15,180 members.[222] Whereas the original Envision software product was a fully integrated enterprise-level software solution, the new CIMS was essentially just a billing system. Adoption of the new software package would necessitate a costly system-wide upgrade. An additional problem involved difficulties and delays associated with Envision's subsequent efforts to make its software Y2K compliant.

In reality, among Envision's customers at the time, only PEC needed the power and flexibility offered by the new software. Consequently, PEC was the only user. The other Envision customers either found another solution better suited to their needs, or continued to use Envision's original UserBase software.

In 1994, prior to the software re-write effort, PEC accounted for approximately 9% of Envision's total sales.[223] By the end of 1999, PEC accounted for more than 90% of Envision's revenue.[224] This

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[218] Letter from Bennie Fuelberg to Toni Reyes, Envision Acting General Manager, Re: Distribution of Software License Agreement to Envision, April 23, 1998.

[219] Board of Directors' Meeting Minutes for Envision Software Corporation, July 28, 1997.

[220] Board of Directors' Meeting Minutes for Envision Software Corporation, September 8, 1997.

[221] The St. Petersburg, Florida office of developers who headed up the software re-write was closed in 2001.

[222] Letter from John J. Kernaghan, General Manager of Envision Utility Software Corporation, to Bennie Fuelberg, May 27, 1994.

[223] Envision Utility Software Corporation, Financial Statements with Accompanying Information for the Years Ended December 31, 1994 and 1993 and Report of Certified Public Accountants. (*Note 10: Pedernales Electric Cooperative, Inc. purchased software support and related services from Envision of approximately $71,020, and hardware and software upgrades of approximately $100,180. The combined total of $171,200 is 8.95% of the total recorded revenue of $1,913,034)*.

increasing dependence of Envision on PEC was largely due to issues related to the re-write of Envision's software. As shown in the table below, Envision "Special Project" revenue, provided by PEC for the software development effort, grew substantially between 1996 and 1999.[225]

Envision Revenue from PEC (1996 - 1999)					
	1996	**1997**	**1998**	**1999**	**Total**
Revenue from PEC					
Special Project Revenue	$546,138	$2,110,765	$2,181,178	$3,101,400	$7,939,481
Other Revenue	403,512	498,593	285,901	816,908	2,004,914
Total	$949,650	$2,609,358	$2,467,079	$3,918,308	$9,944,395
Total Envision Revenue	$1,291,562	$2,973,761	$2,714,866	$4,348,860	$11,329,049
% of Revenue from PEC	74%	88%	91%	90%	88%

As the actual and estimated costs of the software escalated, it appears that PEC and the Envision Board became more receptive to the idea of bringing a third party into the arrangement as a strategic partner; however, efforts were ultimately unsuccessful in identifying and attracting outside participants.

Despite a strong marketing push in 2000, Envision acquired no new customers until 2001, by which time all existing customers with the exception of PEC and Copper Valley Electric Cooperative (which continued to use the old UserBase product) had left. In 2001, when it was determined that not even CSI would be using the new software product, PEC decided to become 100% owner of Envision.

7. PEC's Third Investment in Envision: March 2002

Despite initial indications to the contrary, no CSI customer ever converted to the new CIMS software. As a result, at the May 2001 Envision Board meeting, Mr. Burnett observed that "because CSI was not proposing to use Envision software, it might make sense for PEC to buy their Envision stock."[226] CSI agreed.[227]

PEC authorized the purchase at its Board Meeting in December 2001.[228] The sale was finalized in March 2002 with PEC paying $116,364 for all of CSI's outstanding shares. As part of the agreement, PEC assumed liabilities in the amount of $53,336.[229] The transaction is summarized in Exhibit 11.

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224 Envision Utility Software Corporation, Financial Statements for the Year Ended December 31, 1999 and Report of Certified Public Accountants. (*Note 8: Envision sold Pedernales Electric Cooperative, Inc. $284,274 of computer hardware and software, and another $3,634,034 of support services. The combined $3,918,308 is 90.1% of the Envision's total reported revenue of $4,348,860*).

225 Envision Utility Software Corporation, Financial Statements for the Years Ended December 31, 1996, 1997, 1998, 1999.

226 Board of Directors' Meeting Minutes for Envision Software Corporation, May 22, 2001.

227 Board of Directors' Meeting Minutes for Envision Software Corporation, August 27, 2001.

228 Board of Directors' Meeting Minutes for Envision Software Corporation, December 17, 2001.

229 Stock Purchase Agreement by and between Cooperative Services, Inc. and Pedernales Electric Cooperative, Inc., February 1, 2002.

Upon exiting the partnership, CSI continued to support the UserBase program for the small number of its members who had not yet migrated to a new software solution. CSI closed its doors permanently within a few years.

8. Envision Financial Performance: 2002 – Present

PEC did not make any major changes to the operations of Envision after becoming 100% owner in 2002. Instead, Envision and the CIMS software evolved gradually over the years with the CIMS product, now called "foCIS," undergoing a series of upgrades to keep it current with the latest Oracle releases and to make it compatible with the deregulated electric utility market in Texas. While Envision also provided services to a small number of other customers during this period, it remains almost entirely funded by PEC. In 2007, PEC accounted for over 98% of Envision's source of funds.

One of the most significant software issues that Envision addressed during the past few years was in preparing its foCIS software product for competition under deregulation. In 2003, Envision contracted with Systrends, an information technology consulting company, to evaluate its foCIS system and identify the steps necessary to achieve compliance with the requirements of the Electric Reliability Council of Texas ("ERCOT"), the quasi-governmental organization that manages the Texas interconnected transmission system and deregulated electricity market. By the end of the year, Envision had paid nearly $1 million for Systrends' services.[230] In 2004 however, Envision suspended its efforts.

Since 2002, Envision has only had two notable customers: the Lower Colorado River Authority ("LCRA") and Sharp Community Energy ("Sharp"), a small propane dealer that provides gas to approximately 1,500 residential customers. Envision entered into an agreement to provide service to the LCRA and its retail water customers in 2002. The agreement arose, at least in part, pursuant to the settlement of a dispute between PEC and LCRA.[231] The initial agreement was between LCRA and PEC, which later assigned the contract to Envision.[232] The terms of the agreement called for a $0.5 million payment for "Start-Up Services" and a $1 million prepayment on future billing services. However, in 2004 LCRA reported that it was considering bringing the billing function in-house to reduce costs.[233] In 2006, LCRA terminated the service.[234]

Envision began servicing Sharp in 2004.[235] While the revenue is not significant, Envision argues that it enabled them to develop and put into production a scalable software solution that can readily incorporate new clients.

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[230] Memorandum from Eddie Dauterive, Envision Manager, to Bennie Fuelberg, Re: Systrends Contract Summary, November 6, 2003.

[231] Board of Directors' Meeting Minutes for Envision Software Corporation, May 22, 2001.

[232] Assignment of Services Agreement between Lower Colorado River Authority and Pedernales Electric Cooperative, Inc., May 31, 2002.

[233] Board of Directors' Meeting Minutes for Envision Software Corporation, January 12, 2004.

[234] Board of Directors' Meeting Minutes for Envision Software Corporation, July 27, 2006.

[235] Board of Directors' Meeting Minutes for Envision Software Corporation, July 27, 2004.

A summary of Envision's balance sheet and income statement for the period 1998 – 2007 is included as Exhibits 12 and 13, respectively.

E. Observations and Findings

1. PEC's Decision to Invest in Envision

PEC's desire to own and control its billing software, a perceived competitive advantage at the time, was reasonable justification for its initial acquisition of Envision. This approach was not unique to PEC. Starting in the early 1990's, a number of utilities began to develop customized billing systems with capabilities that exceeded those of the billing systems that existed in the market place. This trend was triggered by the growth of deregulated energy markets. As an example, investor-owned utilities such as Brooklyn Union Gas, Baltimore Gas & Electric, Southern California Edison, Pacificorp, and Duke Energy each invested tens of millions of dollars to develop new technologies, new business processes, and enhanced capabilities. These advances were employed in new customer information systems that provided more flexibility and addressed the issues, challenges, and opportunities presented in a deregulated market.

An enterprise-level software solution, like that provided by Envision in the early 1990s, takes on a life of its own. It requires frequent maintenance and a continuous development cycle to keep pace with its users' requirements. PEC recognized this as both a challenge and an opportunity. From a technological standpoint, PEC was visionary in its understanding of information systems as a source of competitive advantage in the electric utility industry. Ownership of Envision allowed PEC to control its own destiny vis-à-vis its customer service and billing capabilities and offered the possibility that it could market this solution to other electric cooperatives and, through profits generated in this effort, provide benefits to PEC's membership. Such a strategy has been executed successfully, most notably by National Information Solutions Cooperative, known as NISC, a cooperative-owned software developer of financial and billing systems for the cooperative industry.

However, PEC's strategy and methodical approach towards developing the foCIS software was not matched by a similarly thoughtful and deliberate approach to running a technology business. No business case appears to have been developed to assess or justify the costs, or quantify the potential upside or downside risks associated with entering the software business. In fact, PEC's lack of experience in the software business is readily apparent in its dealings and decisions over the years. While limited efforts appear to have been made at various points in time to solicit the input of outside advisors, this advice appears to largely have gone un-heeded.

As PEC's investment in Envision grew from 50% ownership in 1990 to 100% in 2002, a significant benefit of PEC's association with CSI and Envision disappeared, namely the ability to share both development and operational costs across a wider-base of participants. PEC underestimated the costs required to develop the software and to keep it current with Oracle's releases, which necessitated further PEC investment. As other users abandoned Envision, development costs settled increasingly and, ultimately, exclusively upon PEC's membership.

An analysis of PEC's due diligence efforts prior to its 1990 and 1995 acquisitions reveals that PEC used the process to understand Envision's assets and obligations; in other words, to define what Envision was. Noticeably absent is any analysis of what Envision could become or the steps required to ensure the profitability of the venture. In addition, we identified no efforts by PEC to evaluate the alternatives to owning Envision or using Envision software and whether PEC's investment costs would be reasonably recoverable under various scenarios. Essentially, since its first investment in Envision in 1990, it appears that PEC has been more concerned with the technological success of the software than with the economic success of the Envision business.

2. PEC's Total Investment and Expenditures Related to Envision

PEC's direct acquisition costs for Envision amount to some $1.1 million (1990 acquisition: $600K for 50% of Envision, 1995 acquisition: $300K for 25% of Envision, 2002 acquisition: $170K for 25% of Envision). However, PEC's total Envision-related expenditures and investments since its initial investment in 1990 approaches $66 million. This figure includes the acquisition costs, net transfers between PEC and Envision ($49.3 million), outside development costs associated with Envision software ($12.6 million) and other expenditures benefiting the subsidiary ($2.9 million) during the period 1993 - 2007.[236] A summary of Envision expenditures covering the period 1993 - 2007 is included below, with a detailed schedule attached as Exhibit 14.

Summary of Total PEC Expenditures for Envision (1993-2007)

	1993	1994	1995	1996	1997	1998	1999	2000
PEC Payments to Envision	$ 323,500	$ 171,200	$ 624,699	$ 949,650	$2,609,358	$2,467,079	$3,918,308	$ 6,753,069
Less: Envision Payments to PEC	-	-	-	-	-	(119,277)	(660,873)	(356,696)
Acquisition Costs *	600,000	-	300,000	-	-	-	-	-
PEC Payments to Third Parties	-	10,000	648,603	1,120,920	2,241,737	3,177,711	485,541	127,717
Other PEC Costs	71,926	112,516	369,512	321,209	306,372	287,194	125,271	121,242
Total Cost of Envision	**$ 995,426**	**$ 293,716**	**$1,942,814**	**$2,391,779**	**$5,157,467**	**$5,812,707**	**$3,868,246**	**$ 6,645,332**

	2001	2002	2003	2004	2005	2006	2007	Total
PEC Payments to Envision	$7,721,929	$3,795,820	$2,863,200	$3,950,000	$5,987,466	$6,319,191	$5,378,548	$53,833,017
Less: Envision Payments to PEC	(176,723)	(517,023)	(513,790)	(407,125)	(629,283)	(582,216)	(546,870)	(4,509,876)
Acquisition Costs **	-	116,364	-	-	-	-	-	1,016,364
PEC Payments to Third Parties	588,786	1,195,137	1,876,146	972,623	121,914	-	-	12,566,834
Other PEC Costs	150,943	184,224	160,159	187,443	173,329	180,003	202,653	2,953,997
Total Cost of Envision	**$8,284,934**	**$4,774,523**	**$4,385,715**	**$4,702,941**	**$5,653,426**	**$5,916,978**	**$5,034,331**	**$65,860,336**

* 1990 acquisition costs of $600,000 are included in the 1993 column.
** 2002 acquisition costs exclude $53,336 in liabilities assumed by PEC.

Between 1990 and 2002, PEC was invoiced by Envision for the services it received. In 1995, Envision began invoicing PEC for the costs of the software re-write and development effort. In 2002, concurrent with PEC's final acquisition transaction, Envision stopped invoicing PEC and began issuing capital calls. This new accounting treatment followed acknowledgment by Envision and PEC that the software development effort pursuant to the referenced Software Development Agreement had concluded, and that PEC would essentially not be paying for any additional software

[236] Detailed financial and accounting records were not available prior to 1993.

development.[237] The only noteworthy revenue that Envision has recognized since 2002 has been associated with sales to LRCA and Sharp.

Between 2002 and 2007, PEC transferred a total of $28,294,225 to Envision. Prior to June 2003, Envision sent invoices to PEC for specific work performed. Beginning in June 2003, Envision began invoicing PEC at the rate of $350,000 per month for its standard expenses. This amount increased to $400,000 per month in March 2006 due to "personnel … to accommodate efforts to expand [Envision's] customer base."[238]

In addition to the regular monthly transfers, Envision made supplemental capital calls to cover specific expenses such as $1.45 million to establish the San Marcos facility, $1.4 million for bonuses and retirement plan funding, $0.5 million associated with the relocation of the New Mexico office from Santa Fe to Albuquerque, and $0.3 million for video conferencing equipment.

Between 2005 and 2007, PEC's contributed capital to Envision averaged $5.9 million per year. Of this amount, over 70% was used for employment and labor related costs (i.e., salaries and wages, payroll taxes, benefits and insurance, etc.). During this time, Envision on average had about 39 full-time employees. Almost 3.5% of expenses, or approximately $202,000 per year, has gone to travel-related expenses (primarily for travel between New Mexico and Texas). A summary of the contributed capital received by Envision and the employment and labor and travel related expenses incurred by Envision during the period 2002 – 2007 is included in the table below, with a detailed schedule summarizing Envision's sources and uses of funds during the period 2001 – 2007 attached as Exhibit 15**.**

Summary of PEC Contributed Capital and Select Expenses (2002-2007) *

	2002	2003	2004	2005	2006	2007	Total
PEC Contributed Capital	$3,795,820	$2,863,200	$3,950,000	$5,987,466	$6,319,191	$5,378,548	$28,294,225
Employment & Labor Expenses	$2,823,171	$2,942,046	$3,285,715	$3,797,999	$4,243,382	$4,335,291	$21,427,605
% of Contributed Capital	74.4%	102.8%	83.2%	63.4%	67.2%	80.6%	75.7%
Travel Expenses	$243,499	$201,046	$220,007	$199,635	$197,742	$210,907	$1,272,837
% of Contributed Capital	6.4%	7.0%	5.6%	3.3%	3.1%	3.9%	4.5%
Total Select Expenses	$3,066,670	$3,143,093	$3,505,722	$3,997,635	$4,441,124	$4,546,199	$22,700,443
% of Contributed Capital	80.8%	109.8%	88.8%	66.8%	70.3%	84.5%	80.2%

* Envision received capital from sources other than PEC during this time period.

While the Envision foCIS software is a valuable asset to PEC, the historical and current costs incurred by PEC are high and the service received from Envision could be improved. When considering the total investments and expenditures incurred by PEC related to Envision, including capital calls and outside development costs, the costs to PEC averaged $2.69 per customer per month during the

237 Memorandum from Elsbeth T. Peshel and R. Lane Brindley of Clark, Thomas & Winters to Kelly Logan, KPMG, RE: Envision, March 11, 2003.

238 Memorandum from Eddie Dauterive, Envision General Manager, to Envision Board of Directors, Subject: Financials Update, May 10, 2006.

period 1998 – 2007. Industry standards are in the range of $1.50 to $2.00 per customer per month. Accordingly, PEC is spending more on maintaining the software and rendering bills than other utilities. A summary of the average cost per customer per month for PEC is included in the table below.

Cost of Envision per PEC Member per Month 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Annual Cost of Envision	$5,812,707	$3,868,246	$6,645,332	$8,284,934	$4,774,523	$4,385,715	$4,702,941	$5,653,426	$5,916,978	$5,034,331
Average Monthly Cost	$484,392	$322,354	$553,778	$690,411	$397,877	$365,476	$391,912	$471,119	$493,081	$419,528
Number of Members	128,801	138,096	153,266	163,210	173,908	182,321	191,264	200,718	211,940	221,276
Cost per Member per Month	$3.76	$2.33	$3.61	$4.23	$2.29	$2.00	$2.05	$2.35	$2.33	$1.90

Average Cost per Member per Month (1998-2007): $2.69

Efforts made in the past to maintain Envision as a stand-alone entity, as well as its products as stand-alone offerings, have added significant additional cost to PEC. There are a number of notable contributors to this cost including the following:

- Investments to enhance product offerings for sales to outside parties;
- Investments toward the marketing and sales of its products to outside parties;
- The requirement to maintain two offices/data centers, one in San Marcos and one in Albuquerque (in addition to the PEC data center);
- Associated travel costs by Envision personnel in working between the offices/data centers;
- The administrative overhead associated with a separate corporate entity;
- The lack of established product deliverables and an agreed-upon budget; and
- The overall number of employees on the Envision staff.

3. Operational Review and Evaluation of Envision's Software and Technology

Envision's most significant assets are its two proprietary software programs:

- A customer information management system and billing program marketed under the name foCIS ("Fully Optimized Customer Information System").

- A software utility application named ENCODE used to track foCIS-related maintenance requests, personnel time and company expense reports.

Additionally, Envision has documented processes for software enhancement and development to provide assurance that issues are fully analyzed, approaches developed, and solutions implemented in an orderly fashion.

Functionality of foCIS

The functionality of the foCIS software compares favorably with the leading software solutions currently offered. Traditional utility billing software packages associate each account with one location and one meter. This approach severely limits the expandability and flexibility of the software. By comparison, foCIS is based around the customer rather than the meter, allowing PEC to consolidate, provide, and bill for services in a deregulated market, even if the customer is not served at a particular premise or location.

Navigant Consulting performed a high level comparison of the functionality of foCIS to that of other customer information system products currently offered in the utility market. The best known of these products are Oracle SPL, SAP, and Accenture's CSS, which are considered to be the industry leaders in the utility billing sector. The comparison included the assessment of how the systems handle new customer sign-up, move-ins, move-outs, billing inquiries, billing adjustments, meter reads, bill calculation, and bill print. Navigant Consulting determined that the functionality provided by Envision is comparable to that of the industry leaders. Typical implementation costs of these competing solutions range from $15 to $30 million, with subsequent monthly maintenance fees of approximately $2.00 per customer per month.

Continued Upgrades and Enhancements of foCIS

Envision recently spent approximately 18 months migrating the foCIS product to Oracle 10G, the newest Oracle version. The Oracle suite of software solutions is constantly being improved and upgraded. These upgrades are typically issued as releases. Envision's activities to migrate foCIS to the newest Oracle version was a necessary activity. This migration resulted in significant improvement in the speed with which each billing cycle can be invoiced, and has allowed PEC to change its nightly schedule for billing to more effectively use available resources.

Enhancements to Meet PEC's Requirements

Envision's efforts to maintain its software as a stand-alone offering for sale to third-parties have been a competing interest that appears to detract from Envision's primary function of providing services to PEC. For example, the need for Envision to establish modified versions of the software over the years for various customers such as LCRA and Sharp, diverted resources that could otherwise have been devoted to PEC's objectives. With different versions of the software to be maintained, any upgrades to the underlying software would require substantive costs to upgrade each version.

As another example, while the effort undertaken by Envision to prepare the software for a competitive marketplace in compliance with ERCOT is a powerful selling point, at present it is of no operational value to a firm like PEC that does not participate in a competitive market. Still, this is another version that must be maintained and, if upgrades are required, must be enhanced.

Finally, the communication of end-user needs at PEC and the implementation of enhancements currently take longer than if there were a dedicated cadre of software engineers and programmers focused on PEC issues and based in the same location. With the number of staff on the Envision team and the number of PEC applications programming staff, the response to PEC requests should occur more quickly.

4. Envision's Lack of Market Success

As indicated in the discussion above, while Envision has continued to enhance its product offerings over the years, including making sizeable investments towards the marketing and sales of its products, Envision's efforts to expand its client base beyond PEC have proven largely unsuccessful. This in part may be attributed to Envision's lack of both a consistent focus on marketing and sales, as well as a qualified sales team. In addition, the Envision software, while often initially well received by potential customers, ultimately failed to meet certain essential customer requirements including neither having a successful track record and references from other utilities where the software had been installed, nor the availability of an experienced team of consultants who could assist in implementing the software.

While Envision was designed to meet a utility's billing and customer service needs, and Envision staff participated in all of the appropriate industry conferences, it was but one of ten to fifteen utility billing software solutions that were active in the industry during the relevant periods. The utility billing market is quite stratified with end-users defined not only by the type of service (i.e., electric, gas, water, sewer), but by the size and structure (i.e., municipal government, investor-owned, or cooperative) of the utility. The process of selecting a software package can last several years and extend through a number of rounds during which the expectations and requirements are constantly refined and redefined. Envision had difficulty identifying and targeting a market segment where its solution could succeed.

Despite the lack of success over the years, Envision and former PEC Senior Management remained optimistic, a tone which appears to have been continuously reinforced with the Envision and PEC Boards. Interestingly, the assessment of Envision presented in 1988 by Robert R. Coca, President of CSI, is similar to what has recently been presented to the PEC Board by former Senior Management, nearly twenty years later, "I believe that the future holds a reward for our perseverance, and that our investment in Envision will be repaid many times over."[239]

As far back as June 1989, Envision's president recognized the lack of sales success as a marketing issue, stating "the transformation of changing from an organization driven by technology to one driven by marketing is necessary to fulfill the promise of Envision and guarantee success."[240] Nearly ten years later, in early 1998, Envision hired a marketing consultant to evaluate its options. The report was not optimistic and concluded with the following observations:

> *"…several topics were raised which cast…new light on the marketing and sales plans for the Envision products. Based on my somewhat limited experience, these items could make it difficult to enter or compete in the Customer Information System (CIS) marketplace...The use of Oracle is a plus. Not having integration with accounting or purchasing/inventory may be a disadvantage…there is no brand recognition for Envision or CIMS…Profits will be very difficult to achieve with your existing labor base...In summary, I have some reservations*

[239] Cooperative Services, Inc./Envision Utility Software Corporation Annual Report, 1987 - 1988, p. 2.
[240] Annual Meeting Minutes for Envision Software Corporation, June 30, 1989.

regarding the total investment which is required to allow Envision to win clients in today's market."[241]

At various times, Envision appears to have made significant efforts to market its software product but pulled back each time after meeting with limited success and upon encountering various technical challenges. As described above, during a significant part of the 1990s, Envision was involved in the re-write of the software and had little to market. However, after a significant effort to market the re-written software in 2000 and 2001, Envision pulled back after achieving only limited success. Envision regrouped to address certain software issues explaining "Envision's highest priority is to meet the needs of its only customer, Pedernales Electric Cooperative, Inc."[242] This pattern was repeated in July 2004 when it was determined that "Envision's main objective will be to concentrate on system health…."[243]

Efforts to package and market Envision's software to the outside added cost to PEC over the years. Despite the commitment in 2002 and again in 2004 to focus on PEC needs, Envision continued with a primary sales effort directed at El Paso Electric, a large electric utility that services approximately 361,000 customers primarily in west Texas and southern New Mexico. Following initial meetings that appeared promising, Envision expended considerable effort cultivating the opportunity. In fact, since the end of 2004, much of Envision's operational and strategic decisions appear to have been shaped by its pursuit of El Paso Electric, noting in November 2004 that Envision "will concentrate mainly on software implementation activities and less on software changes and enhancements. The goal is to prepare Envision for El Paso Electric and the management of multiple customers."[244]

In early 2006, Envision contemplated relocating its software development team from Santa Fe to Albuquerque, New Mexico, but elected to postpone the move so as not to hinder the anticipated sale to El Paso Electric.[245] While Envision continued to receive positive feedback, in early 2008 El Paso Electric notified PEC that it would not proceed to the next round of the selection process, a fact believed by Envision to have been influenced by the negative publicity around PEC at the time.[246]

During the period 2001 – 2007, Envision incurred over $969,000 in marketing related expenses. Over 50% ($496,948) was incurred in 2001 during Envision's efforts to market the product after the re-write of the software. Marketing expenses for the period 2001 – 2007 are summarized in the table below.

241 Memorandum from Carl Vath, Management Applications Consulting, Inc., to Toni Reyes, Pedernales Electric Cooperative, Inc., Re: Comments on Pricing Meeting, May 21, 1998.

242 Board of Directors' Meeting Minutes for Envision Software Corporation, March 25, 2002.

243 Board of Directors' Meeting Minutes for Envision Software Corporation, July 27, 2004.

244 Board of Directors' Meeting Minutes for Envision Software Corporation, November 30, 2004.

245 Board of Directors' Meeting Minutes for Envision Software Corporation, March 09, 2006.

246 Discussions with Envision Utility Software Company personnel.

Summary of Envision Marketing Expenses by Description (2001-2007)								
Description	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**
Events Expense	$ 174,963	$ 42,899	$ 10,426	$ 21,081	$ 31,810	$ 52,597	$ 74,189	$ 407,965
Media Expenses	163,549	71,284	5,668	1,829	30,040	20,332	18,380	311,081
Creative Development	106,970	726	-	-	-	280	23,669	131,646
Collateral Expense	36,973	4,705	5,271	3,250	233	10,193	15,678	76,303
Duplication/Contract Printing	14,493	2,445	103	2,117	8,327	-	12,228	39,712
Other	-	-	-	-	-	-	3,120	3,120
	$ 496,948	$ 122,060	$ 21,468	$ 28,276	$ 70,409	$ 83,401	$ 147,265	$ 969,827

Envision's marketing and advertising efforts were suspended in early 2008 by PEC and the new members appointed to Envision's Board of Directors following the resignations of Messrs. Fuelberg and Burnett.

5. Organizational/Management Structure

Envision's organizational structure is typical of a stand-alone software company, with an appropriate division of responsibilities and infrastructure required for continued software development, programming and maintenance responsibilities, and administrative and general management.

One aspect of Envision's structure that is unique is the relationship between the Envision General Manager and the PEC General Manager. While the Envision General Manager takes direction from an Envision Board of Directors, he is paid by PEC. The Board of Envision has "ultimate authority over the conduct and management of the business and affairs of the Corporation."[247] The General Manager of PEC has no direct control over the actions of the Envision General Manager, the budget of Envision, or the work performed by the 100% owned subsidiary.

6. Director Compensation, Benefits and Expenses

Envision's corporate bylaws, published in 1990 concurrent with PEC's first investment in the company, gives the Board of Directors authority to authorize compensation for the Board members ("a uniform fixed sum for attendance at each meeting or a uniform stated salary") and reimbursement of all expenses related to meeting attendance.[248] However, Envision's Directors served without pay until 2002. Upon PEC's acquisition of 100% of Envision in March 2002, the Board of Directors passed a resolution authorizing a payment of $750 per meeting to Board members unaffiliated with PEC. Messrs. Mershon and Dalton, the two outside Directors, received total combined compensation of $57,750 during the period 2002 – 2007.

Though Envision Directors did not receive compensation prior to 2002, their meeting-related expenses, and the expenses of the Envision General Manager (who also attended the meetings) were reimbursed. An analysis of Envision's financial records shows Board meeting-related expense

[247] Bylaws of Envision Utility Software Corporation, December 3, 1990, Section 3.01, p. 5.
[248] Bylaws of Envision Utility Software Corporation, December 3, 1990, Section 3, p. 5 – 8.

reimbursements totaled $52,597 for the period 2000 – 2007.[249] However, this figure does not include costs incurred by Messrs. Fuelberg and Burnett as their expenses were paid by PEC. Messrs. Fuelberg's and Burnett's expenses related to Envision during the period 1998 – 2007 total an additional $169,286. A summary of the compensation and expenses for the Envision Board during the period 1998 – 2007 is included in the table below, with a detailed schedule summarizing the expenses by type as Exhibit 16.

Summary of Envision Directors Fees & Expenses

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Compensation											
William Mershon	$ -	$ -	$ -	$ -	$ 3,750	$ 6,000	$ 5,250	$ 5,250	$ 4,500	$ 4,500	$ 29,250
Malcolm Dalton	-	-	-	-	3,750	6,000	5,250	5,250	4,500	3,750	28,500
Total	$ -	$ -	$ -	$ -	$ 7,500	$ 12,000	$ 10,500	$ 10,500	$ 9,000	$ 8,250	$ 57,750
Expenses											
Bennie Fuelberg	$ 3,887	$ 3,489	$ 9,656	$ 17,533	$ 15,565	$ 11,242	$ 17,267	$ 4,195	$ 13,895	$ 3,979	$ 100,708
W.W. Burnett	4,609	2,216	5,235	8,772	7,083	7,167	14,307	8,392	5,471	5,326	68,578
Envision Board / General Manager	-	-	2,917	3,469	2,770	11,396	8,627	10,018	4,597	8,803	52,597
Total	$ 8,496	$ 5,705	$ 17,807	$ 29,774	$ 25,418	$ 29,805	$ 40,201	$ 22,605	$ 23,963	$ 18,108	$ 221,882
Total Compensation & Expenses	**$ 8,496**	**$ 5,705**	**$ 17,807**	**$ 29,774**	**$ 32,918**	**$ 41,805**	**$ 50,701**	**$ 33,105**	**$ 32,963**	**$ 26,358**	**$ 279,632**

7. Management Compensation, Benefits and Expenses

We evaluated compensation paid across the various levels of Envision from 1999 through 2007 pursuant to IRS Form W-2s Wage and Tax Statements produced by Envision for each year. The total Form W-2 wages were reconciled to Envision financial statements in the respective years with no exceptions noted. While compensation was not evaluated by individual employee, the compensation paid to the various levels/job titles is consistent with expectations and did not vary significantly across the employee level and job title. The highest paid employees were the Envision senior management and senior software developers, as would be expected.

8. Non-Employee Compensation – Outside Consultants/Contractors

We evaluated non-employee compensation paid by Envision to outside consultants, contractors and others as reflected in the annual form 1099s for Envision for the period 1999 - 2007. As previously described, Envision is a relatively small company and its use of outside consultants and contractors was relatively limited during the periods in question. No payments were identified to any PEC or Envision-affiliated entities and no payments were determined to be questionable. Only six individuals/entities received payments totaling more than $30,000 during this time period. Two of these six recipients were the National Rural Electric Cooperatives Association and Dell Direct Sales, L.P. The remaining individuals/entities were all reviewed and related primarily to cleaning, construction and software development services.

249 Envision Utility Software Corporation changed accounting systems in 2000. Detailed financial information is not is not available prior to 2000.

9. In Summary

While Envision's software appears to have been well-adapted to PEC's needs over the history of its use, and to have had the potential to be marketed successfully to other similarly situated customers, the potential for outside sales has never been fully realized in a way that benefits PEC and its members or, ultimately, justifies the added marketing, advertising and development costs of its products. Ultimately, Envision's inability to attract and retain customers and service them profitably, coupled with the significant funding requirements associated with the re-write of the software program has negatively impacted Envision's financial performance and required significant investment from PEC.

Envision's divided loyalties between serving the needs of PEC and its members versus the pursuit of third-party software sales has been inefficient and costly to PEC, and has hampered the most efficient application of the software to PEC's needs. Envision's existence as a separate entity has also prevented it from taking advantage of economies of scale and other efficiencies associated with the ability to share resources and costs across PEC's wider base of operations. While Envision's software conceivably could still provide opportunities to harvest additional value, PEC could benefit significantly in the interim through various cost reduction measures associated with a consolidation of Envision with PEC.

F. Recommendations

Based on our efforts to evaluate Envision, Navigant Consulting has provided the following recommendations to the management of Envision and PEC:

Integration of Envision into PEC

- Navigant Consulting recommends that the Envision operations be merged into PEC. In addition, the transition process should be expedited to minimize disruptions to PEC and its members, as well as to avoid the potential loss of key personnel.

- To facilitate the transition process, it is recommended that the Envision General Manager be realigned to report directly to the PEC General Manager, rather than the Envision Board of Directors. The PEC General Manager needs authority to effect change in the relationship between Envision and PEC operations and begin to reduce costs while improving responsiveness of Envision to PEC's needs.

- It is recommended that, at an appropriate time, the Envision entity itself be dissolved, including the Envision Board of Directors. Since PEC is the only owner of Envision, there is no longer a need for outside Directors to represent minority interests' concerns. It is also recommended that efforts be initiated to research the requisite legal, financial and accounting considerations for accomplishing the dissolution.

- We recommend that PEC and Envision jointly form an *Envision Transition Team* to begin the process of defining, planning and implementing an effective transition plan. The transition and merger of Envision and PEC requires careful planning and collaboration to assure that such a transition can be accomplished seamlessly, and with minimal impact on employees of the two companies. It is recommended that the Transition Team should be comprised of representatives from both organizations and, at a minimum, include the following functional groups: Information Technology, Financial, Human Resources, Legal, Accounts Processing, Technical Communications and Facilities. The relative importance of each group's involvement is summarized below:

» *Information Technology*— Opportunities to merge the technology infrastructure currently owned by both entities should be taken. In addition, clear responsibility for managing the foCIS application and managing enhancements will need to be determined.

» *Financial*—Because the financial and accounting records of Envision are maintained as a separate set of books on separate software, planning should be undertaken for a merged chart of accounts and for an evaluation and incorporation of assets and liabilities into the books and records of PEC.

» *Human Resources*—Envision employees will need to be transferred to PEC's payroll and benefits plans. Additionally, relocation planning and assistance will be required for those employees expressing an interest to relocate to Texas from New Mexico.

» *Legal*—As mentioned previously, a number of activities will be required in dealing with the Envision corporate entity, including an evaluation of the impact of New Mexico laws and any impact on PEC's tax-exempt status.

» *Accounts Processing*—Because PEC is the primary end-user of the foCIS software, representation should be provided from the Accounts Processing group at PEC in order to provide its input into planning the transition.

» *Technical Communications*—Because there will continue to be at least two remote employees, and possibly more, planning for technical communications requirements and/or changes will need to be considered in the transition.

» *Facilities*—As Envision transitions out of its New Mexico offices, assistance will be required in evaluating how best to use Envision's San Marcos and PEC's facilities, as well as how best to release the New Mexico facilities.

- It is recommended that *Envision Transition Team's* initial efforts should include:

  » Developing an inventory of the employees, assets, contracts and/or outside consultants and services involved in the transition project.

  » Identifying key Envision employees necessary for continued support, as well as those important to an effective transition, and initiate appropriate retention efforts and/or incentive measures.

- » Designing the appropriate organizational structure and reporting for the consolidated functional area.

- » Determining facility, technology, personnel and other requirements.

- » Identifying perceived obstacles and/or challenges to an effective transition.

- » Developing a detailed transition plan with recommendations for personnel/support changes and steps required to address perceived challenges.

- » Evaluating options for transitioning infrastructure operations (hardware, network, phones, etc.) to the PEC Information Technology staff.

- » Identifying procedures to adapt and/or institutionalize certain software development and project management tools and skills from Envision into the PEC Information Technology organization.

- » Reviewing strategic initiatives with PEC Customer Care, Accounts Processing, and Operations.

Potential Benefits from Sale of Envision

- In addition to efforts to transition Envision into PEC, Navigant Consulting recommends that PEC also undertake to evaluate whether any other sources of value may be derived from the Envision assets, including the rights to the software and tax loss carry-forwards. A recommended course of action would include contacting major utility sector software companies to determine if any have an interest in buying the rights to the software, as well as whether there is any perceived need or value for the tax loss carry-forwards, which are currently of no value to PEC.

Capabilities of foCIS Software to Meet Ongoing Needs of PEC

- Moving forward, it is recommended that PEC evaluate the current and potential capabilities of the foCIS software to support certain strategic initiatives in addressing PEC membership concerns. The most recent J. D. Power customer satisfaction results identified a number of opportunities for PEC to improve its customer satisfaction ratings, areas where foCIS could provide significant advantage, including:

  - » Reducing overall billing costs;
  - » Providing additional billing options;
  - » Offering energy conservation programs;
  - » Providing better communication about power costs; and
  - » Enacting customer assistance programs.

Capabilities of foCIS to Assist in Strategic Initiatives

- In addition, we recommend that PEC evaluate areas where the foCIS solution could assist in strategic initiatives designed to move closer to the electric utility industry vision of the Smart Grid including:

    - » Leveraging the Two-Way Automatic Communication System ("TWACS") with the foCIS solution.
    - » Enhancing customer load control and two-way communications with smart houses and devices.
    - » Adding smart meters to assist in understanding the costs of energy and to assist in credit and collection activities.
    - » Improving customer outage detection and restoration to more accurately identify causes of outages and shorten restoration times.

XIII. Texas Skies

A. Background

Wild Texas Blue, Inc. (dba "Texas Skies") was incorporated on April 20, 2006 by an attorney with the law firm of Clark, Thomas & Winters. Bennie Fuelberg, Eddie Dauterive, and Robert Peterson were listed as Directors.[250,251] The corporation's certificate of formation states:

> *"The purpose for which the corporation is organized is the marketing and sales of WildBlue products and service and the transactions of any and all lawful business for which corporations may be organized under the Texas Business Organizations Code."*[252]

Texas Skies was a subsidiary of PEC created to deliver WildBlue Communications, Inc. ("WildBlue") internet services to PEC members in rural areas where high speed internet was unavailable. WildBlue's website identifies it as a privately owned company that "delivers two-way high speed" internet service to rural homes and small offices via satellite using a mini-dish and modem.[253,254] WildBlue launched its internet service in July 2004. The opportunity to offer WildBlue internet services to PEC's members was made available through a discounted offer from National Rural Telecommunications Cooperative ("NRTC") to UTI, a group of approximately 35 electric cooperatives in Texas, including PEC.[255,256]

The WildBlue high speed satellite internet service was first discussed by the PEC Board in October 2004. The Board minutes indicate that PEC was "not ready to sign a contract, but [was] reviewing" participation in the "NRTC WildBlue high speed internet and satellite."[257] The Board authorized Mr. Fuelberg to "execute an agreement with UTI for participation in WildBlue High Speed Internet" in December 2004.[258] However, an agreement was not executed at that time. Meeting notes from a March 2005 Board meeting state:[259]

> *"WildBlue Update. Eddie, Kimberly, Robert, Hubert & Bennie attended meeting in Dallas. Discovered significant problems with WildBlue. It will not be a monopoly to cooperatives/utilities because DirectTV will also be offering this service. Software is limiting. Manufacturing of dishes are limited & don't really work. Not well tested. PEC will still offer*

[250] Certificate of Formation of Wild Texas Blue, Inc., April 20, 2006.
[251] Mr. Fuelberg, Mr. Dauterive and Mr. Peterson were approved as President, Vice President, and Secretary, respectively, in April 2006.
[252] Certificate of Formation of Wild Texas Blue, Inc., April 20, 2006.
[253] WildBlue Information Sheet.
[254] WildBlue Website.
[255] Letter to Bennie Fuelberg from Kimberly Paffe, Subject: WildBlue Distribution Agreement, December 6, 2004.
[256] UTI – WildBlue Participation Fees, list of electric cooperatives.
[257] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 18, 2004.
[258] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 13, 2004.
[259] BF Board Meeting Notes, March 24, 2005.

> *to do billing & call center services for others offering this service, but we will not be offering to PEC customers. PEC will attend UTI meeting next week and report PEC is backing off."*

However, it is our understanding that discussions continued through the remainder of 2005 with UTI participants and that PEC began testing a small number of WildBlue units in July 2005.[260,261,262] The Board approved the creation of Texas Skies in early 2006. February 2006 Board minutes state that "WildBlue shall be offered by a separate entity owned by PEC, and that a Charter for such entity will be filed as a subsidiary."[263] The minutes also state, "Sheldon Peterson [CEO of National Rural Utilities Cooperative Finance Corporation ("CFC")] will loan PEC 50% to get WildBlue started. Envision Manager Eddie Dauterive's study shows a five-year period before profits."[264] The April 2006 Board minutes state:[265]

> *"[T]hat the organizational documents to form a separate corporation named Wild Texas Blue, Inc. under the cooperative is approved and that any and all assets, including the 200 satellite units being held at the cooperative's training facility, be transferred to Wild Texas Blue, Inc."*

PEC's marketing efforts for Texas Skies began in approximately May 2006, and a $365,710 work order was billed to Texas Skies by PEC on June 30, 2006.[266,267,268] Approximately 46 PEC members signed up for the WildBlue internet service offered by Texas Skies as of July 2006. This number grew to approximately 396 by August 2007.[269,270] However, PEC and other customers of WildBlue experienced problems with the WildBlue equipment and in August 2007 WildBlue notified the NRTC that no new customer accounts could be created because of capacity limitations in relation to the subscriber load on the satellite.[271,272] Texas Skies was subsequently sold by PEC to Central Texas Electric Cooperative on May 30, 2008 for a consideration of $106,377.[273,274]

Texas Skies, which was funded by PEC and customer revenues, recognized a loss during each year of PEC's ownership for the period 2006 – 2008. PEC's total loss, net of the proceeds from the sale, was approximately $640,000. Approximately $380,000 of this loss related to PEC labor allocated to Texas

[260] Letter to Bennie Fuelberg from Hubert D'Spain, Subject: WildBlue Update, July 12, 2005.
[261] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 16, 2005.
[262] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 15, 2005.
[263] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., February 27, 2006.
[264] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., February 27, 2006.
[265] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 17, 2006.
[266] June 30, 2006 Pedernales Electric Cooperative, Inc. Invoice for Texas Skies.
[267] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 15, 2006.
[268] Letter from Mike Vollmer, Eddie Dauterive, and Robert Peterson to Bennie Fuelberg, Re: Texas Skies Capital Call, September 11, 2006.
[269] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 17, 2006.
[270] Texas Skies Monthly Activity Report August 2007.
[271] Texas Skies Monthly Activity Report July 2007.
[272] Texas Skies Monthly Activity Report August 2007.
[273] Asset Purchase Agreement between Wild Texas Blue, Inc. and Central Texas Electric Cooperative, Inc., May 30, 2008.
[274] Texas Skies Asset Acquisition Summary.

Skies. It is possible that a portion of these labor costs may have been incurred by PEC regardless of the Texas Skies investment, albeit in providing services to a different aspect of PEC's business.

B. Scope of Work

Navigant Consulting was retained to investigate the various allegations and questions raised regarding the Texas Skies subsidiary, including reviewing corporate expenditures by PEC in relation to Envision. More specifically, the scope of Navigant Consulting's investigation of Texas Skies focused on the following:

- Identifying and reviewing historical information related to Texas Skies including organizational documents (e.g., Articles of Incorporation and Bylaws) and correspondence.
- Performing detailed searches of publicly available information including searches of public filings with the Texas Secretary of State related to Texas Skies.
- Performing detailed searches of the PEC general ledger to identify any transactions related to Texas Skies for the period 2006 – 2008.
- Identifying Board minutes and/or resolutions related to Texas Skies.
- Identifying and reviewing Texas Skies financial information including financial statements, trial balances, and general ledger data for the period 2006 – 2008.
- Identifying and reviewing detailed account activity for the Texas Skies bank account at Cattleman's National Bank for the period 2006 – 2008.
- Identifying and evaluating information and documents related to the sale of Texas Skies in May 2008.
- Conducting interviews and discussions with Cooperative personnel regarding Texas Skies.

C. Observations and Findings

1. Use of Texas Skies' Funds

The majority of the expenses incurred by Texas Skies appear to relate to the purchase, installation and repair of the WildBlue satellite equipment and PEC labor that was allocated to Texas Skies. We did not identify any payments to PEC Directors or other PEC personnel in relation to the expenditures by Texas Skies. We identified limited travel, meal and entertainment expenses associated with Texas Skies, although it appears that the majority of these expenses were incurred in relation to attendance at various business-related meetings and presentations. In addition, throughout our interviews and discussions with Cooperative personnel, no questions or concerns were brought to our attention regarding inappropriate use of Texas Skies funds or expenses incurred on its behalf.

2. PEC Offering Satellite Internet Service

As with Envision's marketing initiative, preliminary efforts to create a water/sewer entity and retail electric providers, PEC's management during the investigation period seemed open to involving the Cooperative in business interests that were not a core service of an electric cooperative. While a number of electric cooperatives were interested in the WildBlue service, or in other internet initiatives for providing services to rural residents for whom other internet service providers were not available, a large number of PEC's members reside in areas in which other high speed internet service alternatives are available. In fact, the Cooperative's internal estimates for Texas Skies projected approximately 7,500 subscribers in year five and 14,000 subscribers in year ten of the program (less than 4% of PEC's total membership) and a negative cumulative net margin (before income tax) for the first 6 years.[275]

Notwithstanding these less-than optimistic projections, as well as the initial recommendation by PEC personnel in March 2005 to not pursue the Texas Skies investment, the former General Manager nevertheless proceeded to invest Cooperative funds in a venture that was abandoned after a few years of losses. Although PEC's offer of high speed internet service no doubt benefited certain of its members in rural areas, it appears that the vast majority of PEC's members would have not benefited from, nor were they projected to participate in, the services offered by Texas Skies.

3. Cattleman's Bank Account

As described, the Texas Skies bank account was at Cattleman's National Bank and Mr. Fuelberg, Mr. Dauterive, and Mr. Peterson were signatories on the account. We did not identify any transactions in the account detail that were suspicious in nature or required further review.

D. Recommendations

As described in other sections of this Report, many of the Board's decisions relating to Texas Skies, as with other affiliate ventures, appear to have been made without adequate information, consideration, or deliberation. In certain instances it appears the Board may have been denied important information, while in others information appears to have been presented in a light favoring management's preferred alternative. In either instance the Board would not have been presented with information that allowed it to conduct a balanced deliberation and make a well-informed decision on the matters presented for its approval. In the future, we recommend that PEC take very deliberative steps to evaluate fully and carefully the strategic need for creating and operating subsidiaries that do not offer core services of an electric cooperative. The Board should utilize outside consultants, and should avail itself of relevant reports and appropriate studies in order to ensure that the Directors are adequately informed, particularly in connection with decisions entailing significant capital outlays by the Cooperative. Additionally, the Board should critically assess the conclusions offered from use of these tools and make objective decisions regarding the potential for success of such ventures.

[275] WildBlue Business Projections – Member Input Model.

XIV. Director Compensation and Benefits

A. Background

Throughout the course of the class action lawsuit and ensuing criticisms from Cooperative members, the media, and others, questions were raised regarding the compensation paid to Directors relative to the level of effort and value the Directors were providing to the Cooperative. In response, the Board of PEC established a Compensation Committee to conduct an analysis of Board compensation and to report back to the Board with recommendations for adjustments to that compensation going forward, if so warranted.

B. Work Performed

Included in the scope of Navigant Consulting's work was an evaluation and analysis of historical average compensation per Director at PEC, as well as providing assistance to the Board in evaluating Director compensation on a prospective basis. Our efforts included an evaluation of the PEC Board structure, history, responsibilities, and historical compensation philosophy, including the various forms of compensation received by each Director (i.e., per-meeting fee, fixed monthly fee, and benefits). While we analyzed each of the individual components of Director compensation, we approached our analysis of the adequacy of the compensation on an overall basis, rather than as an array of separate elements. Each area reviewed is further described below.

1. Evaluation of Historical Board Roles and Responsibilities

Inherent to the work performed were questions relating to the structure and composition of PEC's Board, including the Board size (i.e., the number of PEC Directors) and the relative responsibilities of voting vs. non-voting (i.e., Advisory) Directors and whether it was appropriate, in light of time commitments and service requirements, for the compensation structure of these two categories of Directors to be aligned.

2. Board Compensation Survey

At the request of the PEC Board, Navigant Consulting conducted a survey of the Director compensation practices at various other cooperatives, as well as at investor-owned utilities ("IOUs"), with characteristics and size similar in nature to PEC. The results of Navigant Consulting's survey were presented to the Board in a report made available to the members on May 19, 2008. That report is herein incorporated by reference and attached as Appendix C.[276]

The report provided a broad perspective on current Board structure and Director pay practices across a wide range of electric utilities and classes of ownership, including electric cooperatives and IOUs,

[276] Information contained in the report was compiled from a variety of sources including publicly available surveys on director compensation, data compiled by Navigant Consulting from publicly available documentation, and informal surveys of electric cooperatives in the United States and Texas.

as well as other publicly-traded companies in the electric utility and energy industry. The work performed by Navigant Consulting included the following:

- Identifying the twenty largest electric distribution cooperatives in the U.S. and the ten largest in Texas, as well as IOUs of similar size, through the Energy Information Administration's rankings of electric utilities by class of ownership, number of consumers, revenues and sales of megawatt hours (2006).[277,278]

- Researching and compiling information from various public, as well as private subscription-based, sources including Annual Reports, Form 10-Ks, IRS Form 990s and/or public company Proxy statements on Board structure, compensation policies and practices, and the various components and amounts of Director compensation.

- Researching and compiling information on various quantitative and qualitative factors for each identified cooperative and IOU including total assets, revenues, consumers/members, miles of energized line, capital expenditures, and number of employees.

- Analyzing Director compensation practices and amounts across the range of entities surveyed, including relative to the various quantitative and qualitative factors identified.

- Performing an informal survey targeted at the senior executives (i.e., General Managers, Presidents, etc.) of the twenty largest electric cooperatives in the United States and in Texas. Surveyed information included: the number of Directors, Board selection process, standing committees, compensation basis and practice, and benefits provided, among others.[279]

- Comparing the results of the survey and analysis to various third-party compensation-related surveys, including a survey by the National Rural Electric Cooperative Association ("NRECA"),[280] available information from the Texas Electric Cooperatives ("TEC"),[281] and information on the general utility and energy industry through a survey performed by the National Association of Corporate Directors ("NACD").[282]

- Developing and implementing a mechanism to receive feedback/comments from the members, which consisted of a weblink on PEC's website, as well as through correspondence received at a Navigant Consulting-provided mailing address.

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[277] Energy Information Administration (Official Energy Statistics from the U.S. Government).

[278] Smaller cooperatives, as well as a majority of publicly-owned (i.e., municipal) utilities, were deemed too small to provide a meaningful basis of comparison consistent with the survey's objectives.

[279] Certain information in the report is based on informal discussions with representatives from various electric cooperatives and is only accurate to the extent such information was adequately relayed and understood.

[280] NRECA – National Directors Survey Results (2007), performed by the NRECA through questionnaires received from 539 electric cooperatives.

[281] Texas Electric Cooperatives report provided to the Senate Committee on Business and Commerce, March 27, 2008, including certain underlying support.

[282] NACD – Director Compensation Report, 2007 - 2008. The National Association of Corporate Directors ninth annual survey of director compensation.

- Presenting the results of the survey and feedback from member comments to the Board's Compensation Committee to assist in their evaluation and recommendation process.

- Interviewing certain current and former Directors regarding their compensation and the effort each routinely expended on behalf of PEC.

3. Limitations on the Work Performed

Given PEC's size relative to other electric distribution cooperatives in the United States and Texas, focusing solely on the practices at other electric cooperatives would not have provided the most reliable and meaningful basis of comparison. In many respects, PEC is more similar in size and certain characteristics to smaller IOUs and publicly-traded energy and utility companies. Nevertheless, significant differences in structure and function between cooperatives and IOUs and publicly-traded energy and utility companies also present challenges to any meaningful comparison.

For purposes of our analysis, we chose to compare PEC to the largest electric cooperatives in the United States and Texas, while also making a comparison to IOUs and publicly-traded energy and utility companies of similar size and characteristics to PEC. We also adjusted (i.e., normalized) the results of our analysis to account for the relative differences in size. While we found both comparisons informative, we placed more reliance on comparisons to other electric cooperatives.

By their nature, surveys contain imprecise information and results may vary widely due to differences in survey methodologies, the manner in which responses are aggregated, and how the results are interpreted and presented. In light of these limitations, caution was exercised in placing too much reliance on one specific source.

In addition, certain information referenced from the NACD and NRECA reports is restricted solely for use by PEC, as the purchaser of the survey information. Information in these reports, as well as others referenced, may also be subject to copyright protection, and therefore has only been referenced and not reproduced in this Report.

C. History

1. Board Structure/Composition

As previously described, the business affairs of PEC are governed by a Board of Directors. PEC's Bylaws provide for up to 17 Directors at any one time (i.e., seven elected voting Directors, seven elected non-voting (Advisory) Directors, and up to four non-voting Advisory Directors at-large who can be appointed by the Board). A profile of the PEC Board of Directors from 1998 - 2007 is provided in Exhibit 17.

PEC's Board was initially formed with only seven voting Directors. However, in response to concerns expressed by members in the early 1970s regarding adequate representation, the position of Advisory Director was created by Board resolution and amendment to the Cooperative's Bylaws in

1975.[283] In addition, the Advisory Director at-large appointed positions were created in 1983 to provide an opportunity for the Cooperative to enlist Board members with specified skills that might be required by the Board at various points in time.[284]

2. Components of Director Compensation

Director compensation for utility entities typically may include a number of components, the most common of which are monthly or annual fees/retainers; per-meeting fees for various Board, committee, or outside meetings; benefits (e.g., health/dental/life insurance); and equity (i.e., stock options or full-value shares at publicly-traded companies.)

PEC compensates its Directors via both a per-meeting fee for attendance at Board meetings and a fixed monthly fee for attendance at meetings other than Board meetings. Directors and Advisory Directors have always been compensated on the same basis. In 2007, PEC's per-meeting attendance fee amount was $750 per meeting and the fixed monthly fee amount was $2,000 per month. During the period 1998 - 2007, PEC also provided various benefits to Directors and their families including healthcare, dental and life insurance, as well as payment for health physicals through a specialized clinic (the Cooper Clinic of Dallas, Texas). Mr. Burnett's compensation is not included in the analysis of Director compensation and benefits as he was treated as a full-time employee of the Cooperative (i.e., Coordinator) and compensated through an annual salary. Mr. Burnett's compensation and benefits are addressed in a subsequent section of this Report. PEC's historical per-meeting and monthly Director's fees, as well as average total compensation per Director, are summarized below:

Summary of Average Director Compensation and Benefits Per Director for 1998 - 2007*

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Monthly Fee	-	-	-	-	$1,500	$1,500	$1,500	$2,000	$2,000	$2,000
Per Meeting Fee:										
Voting Meeting	$750	$750	$750	$750	$750	$750	$750	$750	$750	$750
Non-Voting Meeting	$300	$300	$300	$300	-	-	-	-	-	-
Avg. Fees per Director	$17,063	$16,537	$17,093	$21,276	$29,515	$29,063	$29,900	$34,469	$38,256	$38,531
Avg. Benefits per Director	$5,002	$5,724	$6,485	$7,186	$8,266	$10,040	$9,232	$10,007	$12,068	$11,224
Avg. Total Comp. per Dir.	**$22,065**	**$22,261**	**$23,578**	**$28,462**	**$37,781**	**$39,103**	**$39,132**	**$44,476**	**$50,324**	**$49,755**

* Compensation amounts based on expense vouchers and General Ledger data. Average totals may differ slightly from Form 990.

A detailed schedule summarizing total Director compensation and benefits is attached as Exhibit 18.

Until 2008, the basis of compensation paid to PEC's Directors had not changed since the beginning of 2005, when the fixed monthly fee was increased from $1,500 per month (a level that had been in effect since 2001) to $2,000 per month.[285] Prior to September 2001, PEC utilized a per-meeting fee for outside Board activities (in lieu of the fixed monthly fee).[286]

[283] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 13, 1975.
[284] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 1983.
[285] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 13, 2004.
[286] Pedernales Electric Cooperative, Inc., Board of Directors Meeting Minutes for August 20, 2001.

3. Honorary Directors and Directors Emeritus

In addition to Director and Advisory Directors, the PEC Board authorized the creation of an Honorary Director position in 1986. The Board also authorized the creation of a Director Emeritus position in 1999 to recognize certain retired Directors for their many years of service. During the period under investigation, the Honorary Director was compensated at a flat monthly fee. The Director Emeritus positions were compensated at the per-diem or per-meeting rate for attendance at PEC Board and other meetings.

4. Payment Procedures for Director Compensation

The fixed monthly fee for PEC Directors is set up as a recurring payment and is paid automatically each month to the individual Directors either through direct deposit or via check from PEC. The monthly per-meeting fees are paid following submission of an expense voucher by each individual Director detailing the meetings attended and expenses incurred each month. Until recently, the expense vouchers were submitted to a designated Board member (i.e., the Board Secretary-Treasurer), who processed the reimbursement through a bank account controlled by the Directors. The account was routinely funded through requests for funds from PEC. The Director bank account and expense reimbursement policy are discussed in more detail in another section of this Report.

While the expense voucher process is still in use by the Board, as of December 2007, the vouchers are submitted directly to PEC and paid through the normal accounts payable process. The Board has discontinued use of the Director bank account.

D. Observations and Findings

1. Report on Director Compensation – Survey and Analysis

As described, Navigant Consulting conducted a survey of Director compensation practices across a wide range of electric utilities and classes of ownership including electric cooperatives and IOUs, as well as publicly-traded energy and utility companies of similar size. Navigant Consulting's analysis focused on comparing PEC's Director compensation for the period 1998 - 2007 to the largest distribution cooperatives in the United States and in Texas, to IOUs of similar size, and to data from available compensation surveys from NRECA, NACD, and TEC with respect to electric distribution cooperatives or the utility and energy industry overall.

The results of Navigant Consulting's survey were summarized in a report to the Board that was also made available to the members on May 19, 2008. The observations and findings from the referenced Report on Director Compensation are summarized below.

Board Size and Tenure

In comparison to the cooperatives surveyed, PEC's 17-member Board is the largest Board of those surveyed and significantly exceeds the average Board size observed. PEC's Board is also generally larger than the average Board at various other electric utilities and energy companies, including publicly-traded companies. Average Board size was generally found to be in the range of between 7 and 10 Directors. Our observations regarding Board size are summarized in the table below.[287]

Comparison of Average Board Size Results from Various Surveys

	Average/Median	**Minimum**	**Maximum**
Largest Cooperatives in U.S.	10	7	15
Largest Cooperatives in Texas	9	7	11
NRECA Survey (2007)*	10	6	14
NACD Director Compensation Report (2007-2008)	7-8	-	-
CR Compensation Survey (2007)	7	-	-
PMP – 2007 Director Compensation Report	11	-	-
NRECA – Years of Service on Board	15.6	1	50

* Over 65% of survey respondents had 9 Board members or more and Co-ops serving a larger number of consumers generally have larger Boards.

The average years of service among PEC's Board members was approximately 17 years. In comparison, the NRECA survey noted an average of 15.6 years of service.

Components of Board Compensation

PEC's use of both per-meeting and fixed monthly fees is uncommon among electric cooperatives. However, the practice is widely accepted within the broader publicly-traded energy and utility industry.

The vast majority of cooperatives surveyed compensated Directors on a per-meeting basis ranging from $375 to $750 per meeting (with the NRECA survey noting a $468 average). A few larger cooperatives reported the use of a fixed monthly or annual fee to compensate Directors that ranged from $500 to $1,750 per month. However, this was typically the only fee paid (i.e., no per-meeting fees).

Among publicly-traded companies, fixed monthly or annual payments (i.e., cash retainers) are the most common pay component, with reported use by 95-96% of the companies surveyed. Board meeting fees were the second most common. NACD's survey of smaller publicly-traded energy and utility companies (i.e., $50 million - $1 billion in revenues) reported common use of both per-meeting fees and fixed monthly/annual amounts.[288] Per-meeting fees averaged between $800 and $1,000 per meeting while fixed fees averaged between $1,500 and $2,500 per month.

[287] Sources include: Navigant Consulting's informal survey of the largest cooperatives in the United States and Texas, NRECA National Directors Survey Results, 2007, NACD Director Compensation Report: 2007-2008, Compensation Resources – 2007 Board of Directors Compensation Survey, and Pearl Meyer & Partners – 2007 Director Compensation Report.

[288] National Association of Corporate Directors, Director Compensation Report, 2007-2008.

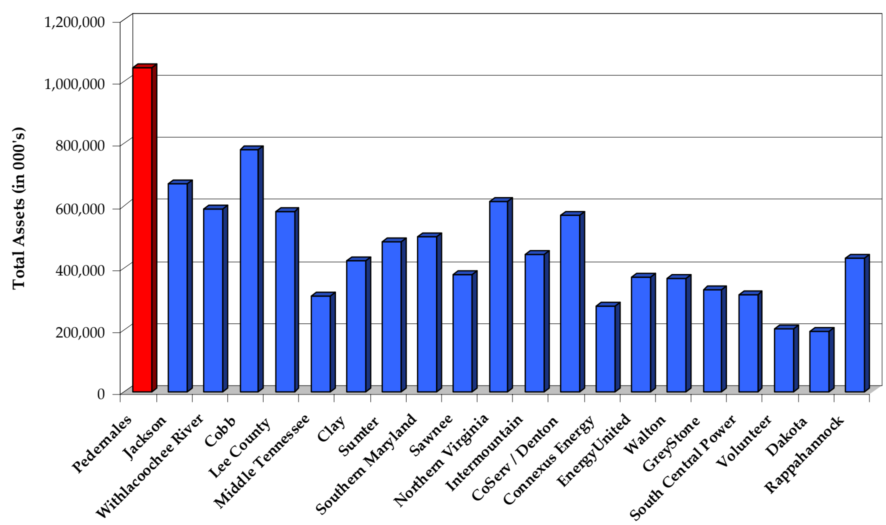
Average Total Director Compensation

Average total compensation per Director at PEC during the period exceeded that for other cooperatives surveyed. In 2006 and 2007, the average Director at PEC received approximately $50,000 in meeting fees, fixed fees and benefits, while average Director compensation was closer to $20,000 for the largest electric cooperatives in the United States and Texas in our survey.[289]

Largest Cooperatives in the U.S.	
Largest	$65,239
75th Percentile	$21,968
Median	$18,703
25th Percentile	$13,905
Smallest	$5,413
Average	$20,887
PEC Average	**$49,997**
* PEC was excluded from the ranges, means and percentiles calculated above	

Largest Cooperatives in Texas	
Largest	$30,827
75th Percentile	$24,855
Median	$19,629
25th Percentile	$12,905
Smallest	$8,400
Average	$19,317
PEC Average	**$49,997**
* PEC was excluded from ranges, means and percentiles calculated above	

However, as described, PEC is the largest electric cooperative out of almost 900 member-owned rural electric cooperatives in the United States, and is significantly larger than many of the larger cooperatives surveyed. As an example, PEC has an asset base that is significantly larger than the next largest cooperative in the United States and almost double that of the next largest cooperative in Texas. A comparison of total assets in the cooperatives surveyed is summarized below:



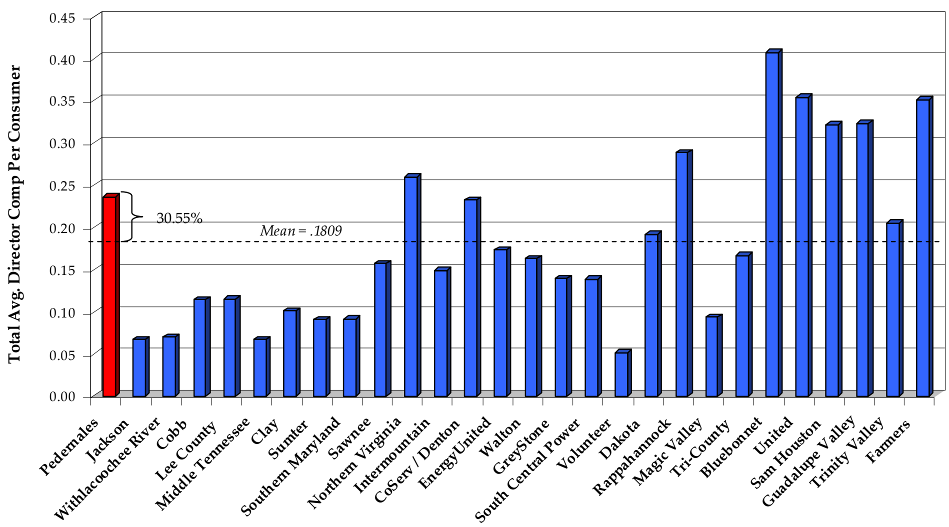
It is generally observed across the various surveys and reports on Director compensation that Director compensation increases with the size of the organization. The NRECA survey on electric cooperatives also made similar observations.[290] To account for this factor, we also adjusted (i.e.,

[289] It should be noted that there are differences in the source years (i.e., 2005 and 2006) for some of the information reviewed, as not all of the information was available for the most current period.

[290] NRECA - National Directors Survey Results, 2007.

normalized) the results of our analysis to take into consideration the relative differences in size between PEC and the other electric cooperatives in our survey. To accomplish this, average total Director compensation was divided by certain bases or metrics of comparison (i.e., total revenues, total assets, capital investment, line miles, employees and members). While arguments can be made with regard to the relevance and/or reliability of such an approach, in aggregate the analysis proved meaningful in providing additional data points from which to evaluate PEC's Director compensation.

Normalized on the basis of size, PEC's compensation data generally fell at or above the median and average for Director compensation at other cooperatives. While in relation to certain metrics, PEC was consistent with the median, as to others PEC was still significantly above. As an example, in comparing the average Director compensation per consumer (i.e., member), the average Director compensation divided by the total number of members for PEC was significantly higher (~30%) than the average of the other cooperatives surveyed (although a number of individual cooperatives were higher than PEC). The results are reflected in the table below.



Charts summarizing the results of the cooperatives surveyed in relation to other identified metrics are included in the Navigant Consulting *Report on Director Compensation* attached as Appendix C.

In addition to electric cooperatives, various IOUs were also included in the survey to the extent information was publicly available as to their respective Board compensation policies. In contrast to electric cooperatives, which on average serve less than 19,000 members, the average IOU serves almost 400,000 consumers and generates close to $850 million in revenues. Our efforts focused on IOUs with consumer sizes and revenues more comparable to those of PEC; these IOUs generally had a range of revenues between ($50 million - $2 billion).[291]

While IOUs are generally significantly larger than PEC and are primarily publicly-traded, to a certain extent both IOUs and cooperatives must attract and retain qualified professionals, including Directors, which, in part, entails making the position economically attractive to qualified candidates.

[291] The investor-owned utilities used in the survey were limited by whether information regarding their Director compensation and compensation practices was publicly available.

In comparison to the IOUs, the average total Director compensation at PEC was significantly below that of Directors of the IOUs surveyed. While PEC's average total compensation per Director averaged close to $50,000 in 2006 and 2007, the average compensation for Directors at IOUs exceeded $120,000. However, given that most IOUs surveyed were also public companies, the common practice of equity-based compensation (i.e., stock option benefits for Directors) must be taken into account for this comparison. Excluding equity-based compensation for the IOUs surveyed, PEC was only slightly below the average Director fees paid by IOUs of approximately $53,000, as reflected in the table below. IOUs typically do not provide health and insurance-related benefits to Directors, so this compensation element is not taken into account.

Survey of Investor-Owned Utilities (IOUs)			
	Average Director Fees	**Average Equity Awards (Stock/Options)**	**Avg. Total Compensation per Director**
Largest	$65,998	$243,586	$242,506
75th Percentile	$63,970	$61,714	$119,014
Median	$61,702	$40,983	$107,511
25th Percentile	$45,426	$32,299	$97,050
Smallest	$23,500	$25,039	$74,994
Average	$53,460	$67,382	$122,438
PEC Average	**$37,928**	**-**	**$49,997**

Source: Compensation data obtained from 2007 Proxy Statements.

Because PEC is smaller than most of the IOUs surveyed, Director compensation was also adjusted to account for the relative differences in size by using the same normalization process as employed in comparing the cooperatives. While certain metrics evaluated may not have the same significance, given the differences between an electric distribution cooperative and the larger IOUs, for consistency uniform metrics were included in our analysis. A normalized comparison of PEC to the IOUs surveyed is summarized in the following table:

Investor-Owned Utilities (IOUs) in the U.S. – Normalized by:						
	Assets	**Revenues**	**Cap. Invest.**	**Line Miles**	**Employees**	**Members**
Largest	.14	.23	4.0	21.2	197.5	.79
75th Percentile	.09	.20	2.2	12.2	139.5	.50
Median	.07	.10	1.1	8.1	79.2	.39
25th Percentile	.03	.07	.26	7.0	49.9	.18
Smallest	.01	.05	.16	3.6	25.5	.10
Average	.06	.13	1.4	9.6	94.6	.38
PEC Average	**.05**	**.10**	**.50**	**3.1**	**61.4**	**.24**

As observed in the above table, normalizing for the differences in size, PEC's average total Director compensation was generally found to be below the average and median compensation for the IOUs.

Comparison to Other Compensation Surveys

The results of our survey of electric cooperatives and IOUs were also compared to other third-party surveys of Director compensation. Results of the NRECA survey found that average Director compensation at cooperatives with greater than 40,000 members was approximately $17,400, which was below the results of our survey. The primary difference resulted from the NRECA's use of cooperatives with "over 40,000 members" as its largest survey category, whereas the average cooperative surveyed was significantly larger.

We also evaluated Director compensation results from the NACD survey, which included results for smaller publicly-traded utility and energy companies (i.e., $50 million - $1 billion in revenues). Average total Director compensation in the NACD survey results was determined to be in the range of approximately $67,000 to $100,000, which was significantly above the average received by PEC Directors.[292] However, this number also included compensation from various equity sources (similar to the IOU comparison noted above). Adjusting for these elements, the remaining Board compensation at smaller publicly-traded energy and utility companies ranged from approximately $36,000 to $52,000.

Total Cost of Board Compensation

In addition to evaluating average total compensation on a per-Director basis, we also analyzed PEC's total costs for the organization resulting from the compensation of its Board. A summary of the total costs incurred by PEC in compensating and providing benefits to its Board is provided in the table below:

Summary of Total Board Related Compensation and Benefits for 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
PEC Director Compensation	$273,000	$248,050	$264,500	$361,700	$501,750	$465,000	$454,500	$551,500	$612,100	$616,500	$4,348,600
Benefits	80,033	85,867	100,668	122,169	140,520	160,642	144,165	160,105	193,095	179,586	1,366,849
Total Comp. and Benefits	**$353,033**	**$333,917**	**$365,168**	**$483,869**	**$642,270**	**$625,642**	**$598,665**	**$711,605**	**$805,195**	**$796,086**	**$5,715,449**
Other Board Related Compensation and Benefits											
Kimble Directors	$ -	$ -	$31,173	$62,232	$60,984	$62,115	$66,500	$9,169	$9,684	$9,864	$311,720
Honorary/Emeritus Director	31,316	7,940	3,614	-	-	27,445	28,930	9,268	-	-	108,513
Retired Director	4,060	4,547	5,261	5,922	2,076	2,398	2,562	2,683	2,855	2,932	35,296
Widows/Former Spouses	5,190	9,052	10,530	10,901	13,530	11,761	14,325	15,571	9,507	9,740	110,107
Total	**$40,566**	**$21,539**	**$50,578**	**$79,054**	**$76,590**	**$103,718**	**$112,317**	**$36,691**	**$22,046**	**$22,536**	**$565,636**
Total Board Related Costs	**$393,599**	**$355,456**	**$415,746**	**$562,923**	**$718,860**	**$729,360**	**$710,982**	**$748,296**	**$827,241**	**$818,622**	**$6,281,085**

Given that the size of PEC's Board is significantly larger than the average Board at other large electric cooperatives and IOUs surveyed, we quantified the total cost to PEC and the other entities surveyed as a percent of each entity's total revenues. The table below summarizes how PEC compared to the other cooperatives and IOUs that were evaluated on a revenue basis.

292 The NACD survey categorizes by size and industry. Survey results for the *Utility & Energy* companies with revenues between $50 million and $1 billion were reviewed in relation to our analysis.

Total Director Compensation Cost as a % of Total Revenues		
	Largest Cooperatives	**Investor-Owned Utilities**
Largest	.21%	.24%
75th Percentile	.13%	.16%
Median	.07%	.10%
25th Percentile	.05%	.07%
Smallest	.03%	.03%
Average	.09%	.11%
PEC Average	**.16%**	**.16%**

As noted, the number of Directors and Advisory Directors at PEC (*17*) is significantly greater than at most other electric cooperatives (*average of 7-10 Directors*), as well as IOUs. As a result, the total Director compensation cost to PEC is significantly greater than at other electric cooperatives and IOUs, including on a per-dollar of revenue basis. In addition, it was observed that total compensation cost as a percent (%) of revenues generally declines as organization size increases; assessed in light of this concept, PEC's total compensation cost appears even more out of line with the observed data.

2. Change in Board Compensation Policy

As described, PEC has historically provided compensation to its Directors on a per-meeting fee basis, with a distinction between whether Directors were attending a "voting" or "non-voting" meeting (e.g., NRECA conferences would be considered "non-voting meetings"). However, beginning in September 2001, PEC eliminated the per-meeting fee for outside Board activities (i.e., non-voting meetings) in lieu of a fixed monthly fee, which was intended to encompass all other services provided by the Directors outside of regularly scheduled and special-called Board meetings.[293] This change in compensation policy appears to have been inconsistent with PEC's Bylaws at the time, and remained inconsistent with PEC's Bylaws through the years until late 2007. The Bylaws in effect prior to September 2001 provided for the following in relation to Director compensation:[294]

- "…a fixed sum and expenses of attendance , if any, may be allowed for attendance at each meeting of the Board of Directors."; and
- "…a reasonable per diem sum and all expenses for their attendance at state, regional and national cooperative meetings and for such other meetings as any member of the Board of Directors or advisory Directors may be directed by the Board of Directors to attend."

[293] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 20, 2001.

[294] Pedernales Electric Cooperative, Inc. Bylaws, Amended at Board Meeting 6-17-00, Article III. Directors, Section 5. Compensation. Note that the Texas Electric Cooperative Act (Texas Utilities Code Chapter 161) at Section 161.073 provides that "A director of an electric cooperative is entitled to the compensation …actually and necessarily incurred by the director as provided by the bylaws."

As used, the term "per diem" relates to "pay for a day's services."[295] And, until September 2001, PEC Board members were compensated on a per-diem basis for their attendance at both voting and non-voting meetings. However, beginning with the first monthly payment of $1,500 to each Director in September 2001, those payments appear to have been inconsistent with the "per diem" term as used.

PEC's Bylaws were revised in November 2007, including the article and section related to Director compensation. The revised and current PEC Bylaws provide for the following:[296]

- "…a fixed sum and reasonable expenses of attendance may be allowed for attendance at each meeting of the Board of Directors"; and

- "… a monthly fee and reasonable expenses for meetings other than Board meetings."

In addition to the perceived inconsistency between PEC's compensation policy and its Bylaws, the 2001 change in compensation policy departed from the standard per diem, or pay for a day's services, that had been the fundamental basis for the Cooperative's compensation of Directors. While it is neither uncommon for Boards outside of the electric cooperative industry to provide a fixed monthly retainer nor for Boards to reconsider and adjust their compensation policy, PEC's change resulted in significant additional compensation for certain Directors (depending on voluntary attendance at conferences or other non-Board meetings) for potentially little or no additional effort.

The change in PEC's compensation policy did not have a significant impact on the compensation received by all Directors, as some Directors appear to have historically received equivalent amounts each month through the $300 per-meeting fee for attendance at various non-voting meetings. However, the addition of the fixed monthly fee (and elimination of the non-voting meeting fee of $300) placed all Directors on a consistent pay scale, regardless of whether they expended the same or additional effort with respect to other Directors.

Prior to the change in 2001, the average annual Director fees (excluding benefits) varied widely from approximately $11,000 to over $20,000 per year, depending on the number of non-voting meetings attended by each Director. However, after the change to the $1,500 per month fixed fee, all Directors were essentially paid the same (averaging approximately $30,000 per year). As a result, both average compensation per Director and total compensation for all of the Directors increased significantly. See Exhibit 19 for a summary of Director compensation and benefits by individual.

Considered from the perspective of PEC's compensation policy as a whole, the increase and change in Director compensation was only part of an overall change in compensation and compensation philosophy instituted by the Cooperative during the period under investigation. The result of these changes was significant increased compensation cost at various levels, including for former Senior Management, the Board and to some extent the Cooperative's District and Department managers. This overall change in compensation philosophy is addressed in more detail in a separate section of the report.

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[295] As defined in Barron's Law Dictionary, Barron's Legal Guides, Third Ed.

[296] Bylaws, Pedernales Electric Cooperative, Inc., revised as of November 9, 2007.

3. Board Compensation Relative to Board Roles and Responsibilities

During the period 1998 - 2007, average compensation per Director, as well as total Director compensation and benefits costs, more than doubled. While it is not surprising that benefits costs (i.e., health, dental, and life insurance) more than doubled – most companies have experienced significant increases in these costs during the same time period – PEC's average and total compensation per-Director also more than doubled, primarily through the change in compensation policy in 2001 and the increase in the monthly fixed fee in 2005, as described. National trends and PEC's own growth might thus be argued to provide some justification for this increase.

Nationwide, Director compensation has continued to increase in recent years, reflecting greater time demands, pressures and responsibilities as a result of heightened attention to good governance practices, including, for example, compliance with Sarbanes-Oxley requirements. A recent survey by the National Association of Corporate Directors noted that Director compensation had increased on average over 10% per year for the last five years.[297] There is also a growing recognition that an increasing proportion of a Director's work takes place outside of meetings.

In addition, the business affairs of the Cooperative became increasingly more complex during the same period as the Cooperative nearly tripled in size. In the abstract, it might be said that the ramifications and importance of effective decision-making and proper governance practices have increased not only in relation to the size of the Cooperative and its members, but also in what generally has become expected of Boards of Directors in meeting their fiduciary duties and obligations in today's business world. For PEC, however, the significant increase in Director compensation since 2001 was not accompanied by any apparent increase in time and effort expended by the Directors or by any significant change in the manner in which the Cooperative was governed.

As described elsewhere in this Report, the PEC Board's role in governing the Cooperative during the period evaluated was largely passive, as the Board appears to have relegated much of its policy-making function and significant aspects of its decision-making to the former PEC General Manager, Mr. Fuelberg. In addition, there is no evidence of increased activity of Board committees, of increased outside meetings, or of other activities that resulted in any significant increase in the average hours devoted per week to Cooperative affairs by PEC Directors from 1998 - 2007, with the exception of additional effort required in connection with the class action lawsuit.

As stated, the results of our efforts to evaluate Director compensation through comparison with various cooperatives and IOUs demonstrate that PEC Directors were paid more during the period under investigation relative to compensation amounts that would be expected for a similarly sized organization. Nevertheless, the level of effort expended by the Directors does not appear to have been commensurate with this higher compensation, nor with the expectations for a Board charged with governing the business affairs of essentially a billion-dollar corporation.

[297] National Association of Corporate Directors, Director Compensation Report, 2007-2008.

4. Compensation for Multiple Board Meetings in One Day

While not explicitly stated, PEC's Director compensation policy over the past ten years appears to have been to compensate Directors per meeting, and not necessarily per day. This conclusion is supported by the fact that on several occasions each year from 1998 - 2007, PEC's Board would hold more than one meeting in a day (sometimes three in one day) and Directors would receive separate per-meeting fees for each meeting. Throughout the ten-year period of investigation, we identified 26 dates for which at least two Board-related meetings were held and for which the attending Directors received multiple per-meeting fee payments for their attendance. As an example, each year on the day of the annual meeting, PEC would hold a regular Board meeting, the Annual member meeting, and then an "organizational" meeting following the Annual meeting. PEC Directors attending all three would receive separate $750 per-meeting payments or $2,250 total for their efforts that day. The additional per-meeting payments are estimated at close to $400,000.

PEC's policy allowing Directors to be compensated multiple per-meeting fees in one day was abolished by Board resolution effective July 21, 2008.[298] The PEC Board resolved that no more than one meeting per day would be compensated for each Director.

5. Bonuses Paid to Directors

Notwithstanding the Board's relatively limited role in connection with policy governance of PEC's activities and significant programs during the period under investigation, in 2006 the Directors were each provided with a Christmas bonus. The bonuses were paid to each Director, Advisory Director and Advisory Director-at-large, and amounted to $1,200 per Director with additional amounts based on the total number of years of service.[299] In the aggregate, the Directors were paid bonuses totaling $31,600.

As with the fixed monthly fee, the bonus payments made to Directors in 2006 appear to be inconsistent with PEC's Bylaws at the time. As described above, Director compensation was defined pursuant to PEC's Bylaws with respect to a per diem basis. The Bylaws do not appear to provide for payments such as bonuses that are unrelated to services provided by Directors in attendance at meetings.

6. Director Benefits

In addition to the compensation received from the per-meeting and fixed monthly fees, Directors were also eligible to receive various health-related benefits from PEC including health care, dental and life insurance, as well as payment for health physicals through the Cooper Clinic. Historically, PEC paid 100% of the premiums for group health and dental insurance for Directors, including

[298] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 21, 2008.
[299] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 11, 2006.

retired Directors, Directors' spouses, and Directors' dependents enrolled in PEC's health plans.[300] In addition, PEC routinely paid for supplemental life insurance.

While the cost of benefits provided to PEC's Directors was a significant value, it has not been uncommon among cooperatives to include some form of benefits as a part of a Director's compensation. Almost half of the cooperatives surveyed provided compensation in the form of benefits to their Directors, mostly through participation in health/dental/life insurance plans.[301] However, it appears that the general trend is away from providing such benefits, based on limited discussions with the NRECA, the cooperatives surveyed, and analysis of historical IRS Form 990s for various cooperatives. In addition, survey data for private entities reflects that relatively few publicly-traded companies provide health and insurance-related benefits to Directors.

The 2007 NRECA survey estimated the average cost of benefits provided by the cooperatives surveyed was $9,164.[302] The average value in benefits received by PEC's Directors ($11,200 in 2007) was not inconsistent with the NRECA's findings. However, PEC also provided benefits to retired Directors, to their spouses and dependents, as well as to widows and former spouses. During the period in question, on average, PEC paid over $10,000 per year in additional premiums for group health and dental coverage on this subsidiary group, as demonstrated in the table below.

Summary of Group Health and Dental Payments on Behalf of Retired Directors and Widows and Former Spouses

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Retired Directors	$4,060	$4,547	$5,261	$5,922	$2,076	$2,398	$2,562	$2,683	$2,855	$2,932	$35,296
Widows/Former Spouses	5,190	9,052	10,530	10,901	13,530	11,761	14,325	15,571	9,507	9,740	110,107
Total	**$9,250**	**$13,599**	**$15,792**	**$16,823**	**$15,606**	**$14,158**	**$16,887**	**$18,254**	**$12,362**	**$12,673**	**$145,403**

A more detailed schedule is attached as Exhibit 20**.**

In addition to the health, dental and life insurance benefits, PEC also extended a specialized benefit in allowing its Directors to receive physicals from the Cooper Clinic, a well-known and highly-regarded medical clinic specializing in preventive medicine, which is located outside of Dallas, Texas. By Board resolution dated January 20, 2003, the Board authorized payment for physicals for PEC managers and the Board. A similar resolution was approved again on July 18, 2005, followed by a resolution extending the privilege to include spouses of PEC Board members and managers.

From 2003 through 2007, the Cooperative paid for approximately $43,301 in expenses related to physical examinations through Cooper Clinic for certain members of the Board and their spouses. The total is summarized in the table below:

[300] The Board decision to pay 100% of the premium for group health insurance for retired Directors and their dependents is evidenced by Board resolutions dating back to at least August 21, 1978.

[301] Several cooperatives surveyed noted that to the extent Directors opted not to participate in offered benefit plans, their compensation would be adjusted upward by the value of the foregone benefit.

[302] NRECA - National Directors Survey Results, 2007, p. 26.

Summary of Director Cooper Clinic Expenses Paid by PEC from 2003 - 2007						
	2003	**2004**	**2005**	**2006**	**2007**	**Total**
Cooper Clinic Expenses	$ 13,941	$ -	$ 6,511	$ 22,427	$ 422	$ 43,301

The Board terminated the practice of paying for expenses related to the Cooper Clinic effective March 20, 2008.[303]

7. Director Emeritus and Honorary Director Programs

By Board resolution dated January 18, 1999, the Board established the position of Director Emeritus for any Director who had served for at least ten years and was at least 72 years of age.[304] The action was to recognize certain retired Directors for their many years of service. The position was initially compensated at a per diem rate for the Emeritus Director's continued involvement in PEC Board and other meetings. The per diem rate was set at $300 for attendance at regular Board meetings and $150 for other activities authorized by PEC.

At the same Board meeting, and effective February 1, 1999, Mr. Harold Kongabel was appointed to the position of Director Emeritus. Mr. Kongabel had served as an Advisory Director in District 2 for almost 25 years from October 1975 until his resignation in January 1999.

The criteria for Director Emeritus status was further revised by Board resolution effective March 17, 2003 to include any Director at least 65 years of age.[305] The compensation was also increased to be proportional to the amount of time the respective Director Emeritus had served as a Director and in correlation with the current fixed monthly fee paid to existing Directors (i.e., Directors Emeritus would receive an amount equal to 3% for each year of service times the current monthly fee – which would be a minimum of 30% of the $1,500 monthly fee at the time). The 2003 resolution also included the provision of medical insurance for Directors Emeritus and their spouses. Effective April 21, 2003, again by Board resolution, Mr. Charles Winters was placed on Director Emeritus status.[306] Mr. Winters had served as both an Advisory Director and Director of District 5 since 1990. The last Board meeting attended by Mr. Winters was in February 2001.

During the period 1998 - 2007, the individuals described above were the only two individuals that held the position of Director Emeritus at PEC. Mr. Kongabel held the position from 1999 until his death in September 2000 and Mr. Winters held the position from 2003 until his death in March 2005. The table below summarizes the amounts paid to the respective individuals during this period:

[303] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 20, 2008.
[304] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., January 18, 1999.
[305] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 17, 2003.
[306] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 21, 2003.

Summary of Director Emeritus Compensation and Benefits for 1998 - 2007									
	1998	1999	2000	2001	2002	2003	2004	2005	Total
Harold Kongabel									
Compensation	$ -	$ 2,850	$ 1,500	$ -	$ -	$ -	$ -	$ -	$ 4,350
Benefits	-	2,285	2,114	-	-	-	-	-	4,399
Charles Winters									
Compensation	-	-	-	-	-	16,500	18,000	6,000	40,500
Benefits	-	-	-	-	-	10,945	10,930	3,268	25,143
Total Director Emeritus	**$ -**	**$ 5,135**	**$ 3,614**	**$ -**	**$ -**	**$27,445**	**$28,930**	**$ 9,268**	**$ 74,392**

In addition to the Director Emeritus program, the Bylaws of PEC were also amended by Board resolution dated April 21, 1986 to enable the election of one Honorary Director of the Board.[307] The past President of the Board, E. Babe Smith, was elected as Honorary Director. Mr. Smith had served in the capacity of President of the PEC Board from 1942 to 1975. He served as Honorary Director from 1986 until his death in March 1999. During that time, Mr. Smith was paid approximately $265,861 in his role as Honorary Director. A more detailed schedule is attached as Exhibit 21.

Summary of Honorary Director Compensation and Benefits for 1998 - 2007			
	1998	1999	Total
Edgar "Babe" Smith			
Compensation	$29,160	$ 2,250	$ 31,410
Benefits	2,156	555	2,711
Total Honorary Director	**$31,316**	**$ 2,805**	**$ 34,121**

The position of Director Emeritus was eliminated by Resolution of the Board on March 20, 2008.[308] The Honorary Director position was eliminated from the Bylaws effective November 9, 2007.

8. Kimble Director Compensation

PEC acquired the Kimble Electric Cooperative ("Kimble") on June 20, 2000. Pursuant to the Kimble/PEC Agreement, the Kimble Board was to be retained as an Advisory Committee for a period of not less than three years.[309] A June 2000 Kimble Board Resolution also indicated that the Kimble Board was to become an advisory committee of PEC and that the Kimble Directors were to receive a monthly advisory payment fee.

The Kimble/PEC Agreement and Kimble Board of Directors resolution did not specify the amount of the monthly advisory payment fee. However, PEC compensated the Kimble Board Advisory Committee members at the rate of $750 per month for a period of approximately 4 and one-half years, until December 2004. In addition, a $1,500 bonus was paid to the Kimble Board Advisory Committee

[307] Resolutions, Pedernales Electric Cooperative, Inc., April 21, 1986.

[308] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 20, 2008.

[309] The June 20, 2000 Kimble/Pedernales Electric Cooperative, Inc. Agreement indicates that Kimble Board Members were to be retained as an Advisory Committee and that one of the Kimble Board members was to become a Pedernales Electric Cooperative, Inc. Advisory Director.

members in December 2004. The compensation paid to the Kimble Board Advisory Committee members is summarized in the table below.

Summary of Compensation and Benefits for Kimble Directors for 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Retainers	$ -	$ -	$ 27,000	$ 54,000	$ 54,000	$ 54,000	$ 50,250	$ -	$ -	$ -	$ 239,250
Bonuses	-	-	-	-	-	-	7,500	-	-	-	7,500
Benefits*	-	-	4,173	8,232	6,984	8,115	8,750	9,169	9,684	9,864	64,970
Total	**$ -**	**$ -**	**$ 31,173**	**$ 62,232**	**$ 60,984**	**$ 62,115**	**$ 66,500**	**$ 9,169**	**$ 9,684**	**$ 9,864**	**$ 311,720**

* Two of the Kimble Directors elected to receive medical/health benefits from PEC while serving on an Advisory Committee for PEC.

9. Past Adjustments to Director Compensation and Benefits Were Discretionary

As described, during the period under investigation, PEC's most significant adjustments and increases in Director compensation occurred in September 2001 (change to fixed monthly fee) and January 2005 (increase to fixed monthly fee), with holiday bonus in December 2006. However, based on an examination of the Board minutes and resolutions, as well as discussions with Directors at that time, we have identified no basis for the change in compensation policy in 2001 and fixed monthly fee amount in 2005. PEC's adjustments to Board compensation in both 2001 and 2005 appear to have been primarily discretionary in nature, with little or no identified basis, benchmarking, or comparison to outside/independent sources to justify the change (e.g., Board pay research or independent compensation studies, etc.).

10. Recent Board Changes to Director Compensation and Benefits

Based in part on recommendations from the Compensation Committee and following the Committee's consideration of the Navigant Consulting report summarized above, in July 2008 the Board revised its compensation to bring it more in line with industry averages and the expectations of PEC's members. By Board resolution dated July 21, 2008, the Board revised the fixed monthly fee from $2,000 per month to $1,500 per month, while leaving the $750 per meeting fee the same.[310] In addition, while agreeing to continue to offer various benefits to Directors and their spouses, the Board determined that the premiums for such benefits should be at the Director's cost, and no longer paid by PEC.[311] The Board also added a $500 per meeting fee for attendance at committee meetings.

An estimate of the anticipated changes in average total Director compensation arising from the Board's decisions, as compared to the prior compensation, is summarized below:

310 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 21, 2008.

311 The Board agreed to continue to provide and pay for group Medicare supplement insurance for Directors elected or appointed prior to June 21, 2008 who have at least ten years service and are 65 years of age or older. Those elected or appointed after June 21, 2008 would still have the option to participate at their cost.

	2006		2007		Revised July 2008	
Avg. Meeting and Fixed Fees per Director	$	37,928	$	38,531	$	34,000
Avg. Benefits per Director		12,069		11,224		-
Avg. Total Compensation per Director	$	49,997	$	49,755	**$**	**34,000**
% Decrease in Avg. Total Compensation						**-32%**

Note: * Average total compensation per Director denoted above excludes any fees or benefits paid to W.W. Burnett.

Based on projected estimates, in comparison to other electric cooperatives, average total Director compensation of under $35,000 for PEC would be at, or below, the median and average when compared on the bases of per-dollar of revenues, value of assets, or number of members. Average Director compensation of under $35,000 per year, based on these recent policy changes, would effectively return PEC's average Director compensation to its level prior to the change in 2001 (7-8 years ago).[312] In addition, the elimination of Director health benefits would also be consistent with industry trends, which appear to be moving away from providing compensation to Directors in the form of benefits.[313]

E. Recommendations

The Board has already taken significant steps to adjust Director compensation, with the formation of the referenced Compensation Committee and its efforts to evaluate Director compensation and benefits. This effort led to the Board's agreement to adjust the Directors' monthly retainer and essentially eliminate PEC's payment of the premiums for Director benefits as described. In addition to the Board's decision to reduce compensation, the Board changed its policy to disallow the payment for multiple meetings in one day and eliminated the Honorary and Director Emeritus positions.

Navigant Consulting considers the Board's changes as summarized above to be appropriate. Based on our evaluation of Director compensation and benefits, Navigant Consulting recommends the following further actions:

Compensation Committee

- It is recommended that the Board establish a standing Compensation Committee for evaluating not only Board compensation and benefits, but also the compensation and benefits provided to Senior Management, as well as the Cooperative's employees.

- It is also recommended that the Board prepare a written charter for each standing committee of the Board including defining the purpose, responsibilities and/or authority of the committee and recommended number of meetings expected from each committee per year.

[312] Estimate based on $1,500 fixed monthly fee, fourteen regular/special Board meetings, and various Board workshops and committee meetings.

[313] According to the NRECA survey cited earlier, approximately 37% of NRECA members provide these benefits to directors.

Periodic Review and Evaluation Process

- Through the Compensation Committee, it is further recommended that the Board establish a periodic review process with benchmarking to peers and industry practices in order to ensure that Directors continue to be adequately compensated for their time and effort, but also that compensation remains aligned with industry best practices and the long-term interests and expectations of the members.

Board Roles and Responsibilities

- Navigant Consulting also recommends that the Board consider defining, in written form, the following: (1) expectations, roles and obligations of the individual Directors and their expected participation in Board committees, training and other Cooperative sponsored events; and (2) Board duties to provide effective oversight to Senior Management and the Cooperative, and provide policy-making advice and guidance to Senior Management in connection with key operating decisions, regulatory compliance, and corporate governance.

- It is also recommended that the Board clearly delineate between the expected duties and responsibilities of Directors and Advisory Directors in relation to the Board and committee meeting fees and articulate the purpose of the fixed monthly fee.

Board Size – Role of Advisory Directors

- To further address total Director compensation costs to PEC, it is recommended that the Board establish a committee to evaluate the current number of Directors and Advisory Directors, and the relative responsibilities of each from a voting and non-voting perspective.

- Through this committee process, it is also recommended that the Board evaluate the need for the Advisory Director position, as well as the reasonableness of aligning compensation among the Directors and Advisory Directors. While the potential for enhanced representation may be achieved through the Advisory Director positions, questions arise as to the whether or how much additional value is brought to PEC's Board function through this concept, relative to the added costs. Given their lack of voting authority, the Advisory Directors' ability to provide effective input into managing the business affairs of the Cooperative is questionable.

XV. Director Expenses/Expense Reimbursement

A. Background

In addition to questions raised regarding Director compensation, concerns were also raised in relation to expenses paid by the Cooperative during the period under investigation that were incurred by, or on behalf of, the Directors. Questionable expenditures in relation to various hotel stays, air travel, meals and other items were highlighted from information produced in connection with PEC's class action lawsuit. Expressed concerns related to the perceived excessive or "lavish" and "extravagant" nature of some of the expenditures, as well as whether certain expenditures were reasonable and necessary in the conduct of the Cooperative's business.

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and evaluating expenses incurred by the Board during the period 1998 – 2007. Inherent to our efforts was the review and evaluation of the various procedures by which Board members were reimbursed for expenses incurred directly by the Board, or paid by the Cooperative on their behalf. We also attempted to evaluate the existing and/or ad hoc policies, if any, the Board followed in determining whether expenses were appropriate and reasonable for reimbursement. In addition, in investigating the expenses incurred, we endeavored to categorize expenses by expense type (e.g., lodging, airfare, meals, etc.) and to correlate those expenditures, to the extent possible, with the business reason or purpose for the expenditures (e.g., Board meetings, workshops, conferences, etc.). More specifically, the scope of our work included the following:

- Identifying and evaluating current and historical Board travel and expense reimbursement policies, including relevant Board minutes and resolutions related to expenses and expense reimbursement, and summarizing policy changes over time.

- Documenting business processes and procedures established and/or followed regarding expenses and expense reimbursement for Directors, including relevant controls.

- Identifying the relevant PEC General Ledger account(s) in which Board-related expense items were coded and identifying amounts reimbursed to Directors, or paid on their behalf, through each account.

- Searching PEC's accounts payable system by payee for additional payments to Directors and reconciling to reported compensation, benefits and expense reimbursement amounts.

- Preparing schedules summarizing Director expense reimbursements by Director/payee for the period 1998 – 2007.

- Identifying corporate credit cards used for Board-related purposes, obtaining historical statements from PEC and credit card companies, and summarizing card usage and expenses by period for the Directors during the period 1998 – 2007.

- Analyzing larger expenditures including lodging, airfare, spouse airfare, meals and entertainment, and determining the corresponding purpose for the expense (e.g., Director meeting, conference, other).[314]

- Evaluating Director expenses relative to their reasonableness and necessity, and comparison to general industry expense reimbursement guidelines.

2. Director Expense Policy

Based on our understanding from discussions and document reviews, PEC never promulgated a formal expense reimbursement policy with respect to the Directors during the period 1998 – 2007. The only expense reimbursement policy identified, a 1991 policy, related to PEC employees. Similar to other standard expense reimbursement policies, the policy provided for the reimbursement of "all business related expenses incurred in carrying out work assignments."[315] The policy addressed the types of expenses covered (e.g., hotel, air travel, meals, and other bona fide business expenses, etc.), as well as the required documentation to support the reimbursements made. In tandem with the policy, PEC incorporated the use of both a *Travel Expense Voucher* and a *Business Expense Voucher*, with the latter being for all other "bona fide business expenses incurred by employees in the performance of their official duties with the Cooperative."[316] However, the policy provides no real guidance or limitations on either expense types or amounts considered appropriate for reimbursement.

A general standard for reimbursement of Director expenses applicable to cooperatives is provided by the Texas Electric Cooperative Act, which states: "A director of an electric cooperative is entitled to the compensation and reimbursement for expenses actually and necessarily incurred by the director as provided by the bylaws."[317] Article III, section 5 of the PEC Bylaws states that "by resolution of the Board of Directors a fixed sum and expenses of attendance, if any, may be allowed for attendance at each meeting of the Board of Directors" and that "Directors and advisory directors shall be allowed a reasonable per diem sum and all expenses for their attendance at state, regional and national cooperative meetings and for such other meetings as any member of the Board of Directors…"[318] No additional general or specific guidelines relating to expense reimbursement policies or procedures

[314] "Spouse" expenses include expenses for individuals (i.e., girlfriend) accompanying Directors on Board related travel.

[315] Expense Reimbursement Policy, Adopted by Board of Directors on December 17, 1990. Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 17, 1990.

[316] Memorandum from Bennie Fuelberg to All Managers, Re: Expense Reimbursement Request Forms, February 11, 1991.

[317] Texas Utilities Code, Title 4. Delivery of Utility Services, Subtitle A. Utility Corporations and Other Providers, Chapter 161. Electric Cooperative Corporations, Subchapter B. Creation and Operation of Electric Cooperatives, § 161.073. Compensation of Directors.

[318] Pedernales Electric Cooperative, Inc. Bylaws, Article III, Section 5. Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc. for October 27, 1997.

with respect to the Board were identified in the Board meeting minutes and resolutions reviewed for the period under investigation.

The Internal Revenue Code of 1986 ("tax code") requires that travel expenses not be "lavish or extravagant under the circumstances," though "lavish" and "extravagant" remain undefined in the tax code or in regulations.[319] The IRS has provided detailed guidance for managers in avoiding lavish, extravagant or excessive expenditures.[320] Travel expenses that are paid or reimbursed but not properly documented, or that are "lavish or extravagant" in nature are treated as taxable compensation to the individual so benefiting. In addition, the payment of travel for an employee's spouse may also be treated as taxable compensation.

3. Director Expense Payment and Reimbursement Procedure

Expenses and compensation related to the Board were booked to PEC's General Ledger under Account # 835 – *Director Fees and Expenses* (GL Acct. # 835). Included under GL Acct. # 835 were: 1) payments made by PEC to a Director-controlled bank account used for reimbursing Directors for meeting fees and expenses, 2) payments for expenses incurred on behalf of Directors through a PEC credit card designated for travel expenses, 3) payments for expenses incurred on behalf of Directors that were paid directly by PEC, and 4) the monthly fixed fee payments made to Directors as part of their compensation. The total expenditures booked to these four categories are summarized below, with a more detailed schedule attached as Exhibit 22.[321]

Summary of GL Acct. # 835 - Director Fees and Expenses by Category for 1998 - 2007

Payee Name	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Fees											
Fixed Fee Payments and Bonuses	$9,000	$2,250	$27,000	$189,000	$357,000	$333,000	$348,750	$382,000	$415,600	$384,000	$2,447,600
Expense Vouchers	273,000	250,900	266,000	259,700	195,750	175,500	178,500	175,500	196,500	232,500	2,203,850
Total Fees	$282,000	$253,150	$293,000	$448,700	$552,750	$508,500	$527,250	$557,500	$612,100	$616,500	$4,651,450
Expenses											
Expense Vouchers	$22,684	$20,013	$20,573	$25,081	$31,734	$70,120	$87,134	$93,468	$79,800	$96,849	$547,457
Credit Card Expenses	4,114	16,933	51,324	71,003	56,031	92,070	63,296	60,526	70,836	27,730	513,863
Direct Billed Expenses	107,914	103,555	102,578	133,997	105,394	45,591	43,049	34,065	68,191	75,018	819,354
Accruals and Reversals	(2,800)	33,171	(6,217)	(24,154)	27,877	4,836	3,839	19,657	(27,623)	(28,585)	-
Total Expenses	$131,912	$173,672	$168,259	$205,927	$221,037	$212,617	$197,318	$207,716	$191,204	$171,012	$1,880,674
W.W. Burnett Expenses	-	-	-	-	-	-	-	-	1,523	9,635	11,159
Reconciliation Adjustments*	(36,203)	59,540	(12,750)	22,025	(21,285)	25,990	(31,631)	(21,716)	28,225	25,686	37,882
GL Acct. # 835 Total	**$377,709**	**$486,362**	**$448,509**	**$676,653**	**$752,502**	**$747,107**	**$692,937**	**$743,500**	**$833,053**	**$822,834**	**$6,581,165**

* Reconciliation Adjustments relate to timing differences in the reimbursements of the Directors' Bank Account in the GL and missing expense vouchers.

Note: Expenses incurred by Mr. Burnett were routinely booked as expenses of the Cooperative, and were not typically recorded in GL Acct. #835. Expenses incurred by Mr. Burnett, or paid on his behalf, are analyzed in more detail in the subsequent section to the Report.

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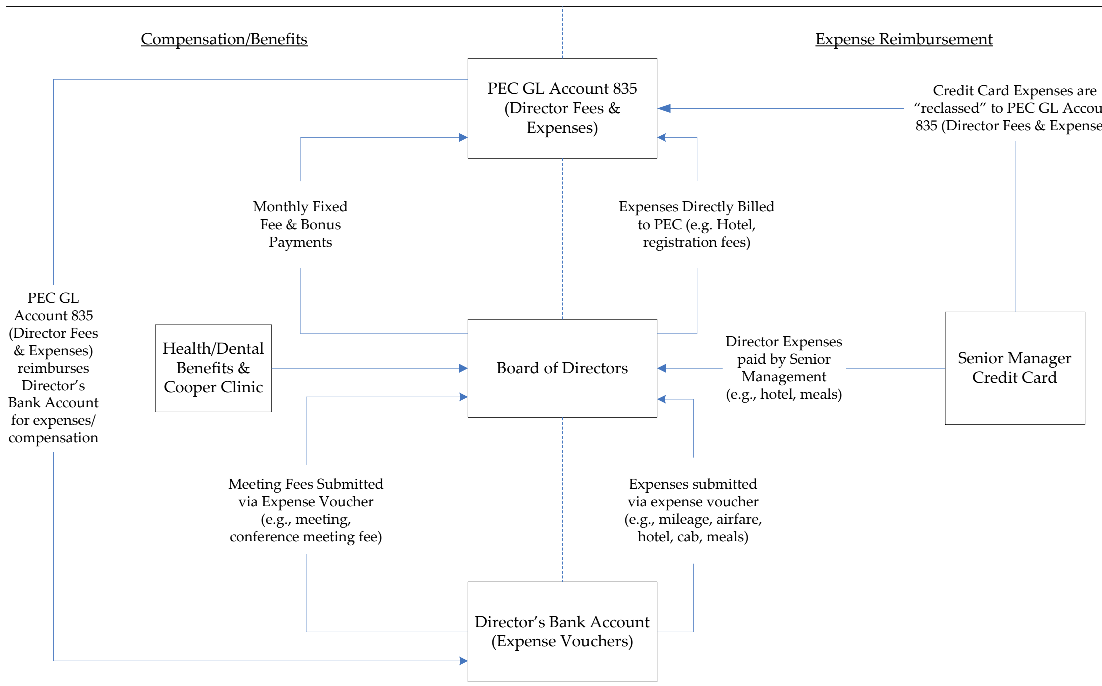
[319] The Code of Laws of the United States of America, Title 26 § 162; CFR26 Chapter 1 §§1.162-2, 1.162-17.

[320] IRS Publication 463, Travel, Entertainment, Gift, and Car Expenses (2007).

[321] During most of the periods in question, Mr. Burnett was reimbursed for expenses through Pedernales Electric Cooperative, Inc.'s accounts payable process and not through the Director-controlled back account, with the exception of 2006 and 2007.

The following flow-chart diagram depicts procedures by which the Director fees and expenses were paid by PEC and/or reimbursed by PEC to the individual Directors:

Summary of Board of Director Compensation and Expense Reimbursement Payment Process



As diagrammed above, Director expenses were incurred and/or paid by three primary means:

1. *Directors' Expense Vouchers* - Expenses incurred by Directors and reimbursed indirectly by PEC through the Board's monthly submission of Director Expense Vouchers.

2. *Direct Billed/Paid* – Expenses incurred on behalf of Directors but paid directly by PEC.

3. *Credit Cards* – Expenses incurred through a PEC credit card (i.e., travel card) on behalf of the Directors, which was also paid directly by PEC.

We analyzed detailed accounting and backup support information for each of the expense categories described above. We requested and were provided with copies of the Directors' Expense Vouchers, credit card statements, and general ledger account detail for the period 1998 – 2007, as well as available backup support. We estimate that our investigation encompassed the review of close to 2,000 expense vouchers and supporting information, as well as 109 months of credit card statements for six different credit card accounts. In addition, with regard to expenses paid directly by PEC, we estimate that we evaluated over 4,300 transactions booked to GL Acct. # 835 during the period 1998 - 2007. The results of our efforts are summarized below.

4. Summary of Director Expenses

As described, fees and expenses related to the Board were ultimately booked to PEC's GL Acct. # 835. However, reimbursements to the Directors for their per-meeting fees and expenses through the Directors' Expense Vouchers were not individually recorded in GL Acct. #835. Only the total amount reimbursed to the Director's bank account each month was booked to GL Acct. #835. Given this limited aggregate information, our analysis of the Director expenses necessarily included review of the underlying individual Directors Expense Vouchers, as well as the detailed credit card statements.

We analyzed the expenses reimbursed to the Directors through the monthly Directors' Expense Vouchers, as well as expenses paid directly by PEC through its normal accounts payable process or through PEC-issued credit cards to provide an overall accounting for expenses incurred by, or on behalf of, the Directors during the period 1998 – 2007. A summary of the total Director expenses categorized by expense type is provided below:

Summary of Total Director Expenses for 1998 - 2007

Expense Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Lodging / Meeting Rooms	$47,514	$40,976	$67,372	$91,923	$76,321	$61,753	$71,773	$70,845	$96,665	$103,071	$728,214	39%
Registration Fees	19,180	21,303	35,420	41,058	33,490	28,036	24,046	31,276	35,587	26,731	296,126	16%
Airfare	21,636	31,789	19,814	7,313	5,697	40,836	25,731	22,155	23,741	10,709	209,419	11%
Moursund and Moursund	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400	144,000	8%
Meals	8,304	7,731	6,209	18,131	14,775	11,533	24,985	13,725	11,404	19,326	136,123	7%
Mileage	9,106	5,801	9,596	10,523	14,434	12,239	13,052	10,819	12,980	16,483	115,033	6%
Spouse Airfare	-	5,092	11,836	2,540	9,462	25,058	12,464	11,162	14,042	3,450	95,103	5%
Misc. / Tips	1,732	1,775	2,517	2,977	2,844	5,971	3,820	5,693	5,882	3,024	36,236	2%
Other	6,580	7,214	2,836	(688)	3,203	6,101	1,774	4,600	(311)	1,413	32,723	2%
Cab	2,147	3,152	2,221	1,779	1,893	1,810	4,731	2,779	2,922	990	24,423	1%
Unclassified	4,114	1,269	2,256	40,125	16,642	44	(3,296)	605	1,515	-	63,273	3%
Total Expenses	**$134,712**	**$140,501**	**$174,476**	**$230,081**	**$193,160**	**$207,781**	**$193,479**	**$188,059**	**$218,827**	**$199,597**	**$1,880,674**	**100%**

All Director fees and expense-related payments appear to have been booked to PEC's GL Acct. # 835. Each of the methods by which Director expenses were paid or reimbursed is further discussed below.

5. Director Expenses Paid thru the PEC Director's Account (Expense Vouchers)

During the period 1998 – 2007, Directors were reimbursed for expenses and compensated in connection with the monthly meeting fees through the submission of a monthly expense voucher. This part of the Director compensation and expense reimbursement process was controlled entirely by the Board (i.e., the Board Secretary-Treasurer), and Directors were compensated from a Director-controlled bank account. In general, at each Board meeting the Board Secretary-Treasurer would request reimbursement from PEC's cash management department for the current month's meeting fees and expenses incurred by Directors since the prior meeting. Upon funding of the Directors' bank account, the Board Secretary-Treasurer would distribute checks to the respective Directors.

In support of their requests for payment and expense reimbursement, the Directors were required to submit a Directors Expense Voucher. The expense vouchers were submitted to the Board Secretary-Treasurer, who was responsible for their review and reimbursement by PEC. The Board used the same expense voucher form from 1998 - 2007. A simple one-page form, the Directors Expense Voucher allowed for the breakout of Director expenses by the per-diem meeting fee, lodging, meals, cab fare, mileage and miscellaneous with a date and description field for each. A sample Directors Expense Voucher form is provided as Exhibit 23.

The total expense amounts reimbursed to PEC Directors through the expense vouchers during the period 1998 – 2007 are summarized below:

Summary of Director Expenses from Expense Vouchers for 1998 - 2007

Expense Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Lodging	$1,321	$2,033	$553	$1,655	$9,423	$38,509	$60,027	$59,476	$48,075	$67,663	$288,737	53%
Mileage	9,106	5,801	9,099	9,601	12,767	11,319	11,435	10,819	12,980	16,483	109,409	20%
Meals	7,965	7,331	5,458	9,402	4,796	8,586	7,509	7,864	7,678	5,049	71,638	13%
Misc. / Tips	1,732	1,775	2,517	2,977	2,844	5,971	3,820	5,693	5,882	3,024	36,236	7%
Cab	2,147	3,152	2,221	1,779	1,893	1,810	3,978	2,779	1,963	990	22,711	4%
Airfare	318	-	-	-	-	1,142	1,294	6,058	3,349	3,539	15,700	3%
Other	96	(78)	725	(333)	12	2,783	(929)	778	(127)	100	3,027	1%
Total Expenses	**$22,684**	**$20,013**	**$20,573**	**$25,081**	**$31,734**	**$70,120**	**$87,134**	**$93,468**	**$79,800**	**$96,849**	**$547,457**	**100%**

With the exception of the monthly requests for funding or replenishment of the Board's bank account, this expense reimbursement process was outside of PEC's normal accounts payable and cash management process and the purview of the Finance Manager at PEC. The process was controlled almost entirely by the Board, with little PEC staff involvement or visibility in the process.

The Directors' expense reimbursement process appears to have been based essentially on the "honor system" with little or no apparent review or audit of the expenses submitted for reimbursement. This ad hoc procedure, lacking any audit or review mechanism, is consistent with the absence of any formal PEC expense reimbursement policy or guidelines.

6. Director Expenses Billed to and/or Paid Directly by PEC

PEC also routinely paid for expenses incurred on behalf of the Directors for lodging and airfare for individual Directors, or for the Director group as a whole, in connection with organized trips to meetings and conferences (e.g., the NRECA Annual Meeting). Many of these expenses would be direct-billed and/or paid directly by the Cooperative through its accounts payable process without the need for Directors to include these amounts on their periodic expense voucher submissions. A summary of expenses incurred and paid directly by PEC include the following, with a more detailed schedule attached as Exhibit 22.

Summary of Direct Billed Expenses from GL Acct. # 835 - Director Fees and Expenses for 1998 - 2007												
Expense Type	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**	**% of Total**
Lodging / Meeting Rooms	$46,193	$39,269	$63,767	$90,677	$65,529	$9,906	$15,446	$5,133	$19,828	$32,792	$388,540	47%
Registration Fees	19,180	17,523	21,911	26,072	19,490	16,756	8,175	11,555	33,832	24,356	198,849	24%
Moursund and Moursund	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400	144,000	18%
Airfare	21,318	24,725	40	2,624	-	-	-	-	-	-	48,707	6%
Other	6,485	7,239	1,917	(699)	2,354	2,173	1,221	1,624	(524)	785	22,575	3%
Meals	339	400	47	-	1,953	1,436	2,191	1,353	655	2,685	11,058	1%
Mileage	-	-	497	923	1,667	920	1,617	-	-	-	5,624	1%
Total Expenses	**$107,914**	**$103,555**	**$102,578**	**$133,997**	**$105,394**	**$45,591**	**$43,049**	**$34,065**	**$68,191**	**$75,018**	**$819,354**	**100%**

7. Director Expenses Paid through Credit Cards Issued to PEC Managers

During the period under investigation, it was common for PEC to book and pay for certain expenditures on behalf of the Directors through PEC-issued credit cards. Many of these expenditures related to airfare, conference registration fees, meeting room expenses and group meals. However, there is no indication that any PEC Director, including Mr. Burnett, was ever issued a credit card through PEC. Most of the expenses were incurred through a designated "travel card" issued in Mr. Fuelberg's name but reportedly used primarily for Board travel expenses, while some were also incurred on Mr. Fuelberg's card as well as on the credit cards of one or more of the PEC managers. The travel card was maintained by the various assistants to Mr. Fuelberg working in the former General Manager's office. A summary of expenses paid by PEC credit card through GL Acct. # 835 include the following:

Summary of Director Credit Card Expenses in GL Acct. # 835 - Director Fees and Expenses for 1998 - 2007												
Expense Type	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**	**% of Total**
Airfare	$ -	$7,065	$19,774	$4,689	$5,697	$39,694	$24,437	$16,097	$20,392	$7,170	$145,013	28%
Registration Fees	-	3,780	13,509	14,986	14,000	11,280	15,871	19,721	1,755	2,375	97,277	19%
Spouse Airfare	-	5,092	11,836	2,540	9,462	25,058	12,464	11,162	14,042	3,450	95,103	19%
Meals	-	-	704	8,729	8,026	5,446	11,351	4,508	3,071	11,592	53,427	10%
Lodging / Meeting Rooms	-	(326)	3,052	(409)	1,368	9,404	234	6,236	28,762	2,616	50,937	10%
Other	-	53	194	344	836	1,145	1,483	2,198	340	528	7,121	1%
Cab	-	-	-	-	-	-	753	-	959	-	1,712	0%
Unclassified	4,114	1,269	2,256	40,125	16,642	44	(3,296)	605	1,515	-	63,273	12%
Total Expenses	**$4,114**	**$16,933**	**$51,324**	**$71,003**	**$56,031**	**$92,070**	**$63,296**	**$60,526**	**$70,836**	**$27,730**	**$513,863**	**100%**

8. Analysis of Director Expenses

We further analyzed each component of the Director expenses to identify business reasons or purposes for the expenses, as well as to address perceived concerns regarding the reasonableness and necessity for such expenses, and the issue of whether certain expenses were excessive in nature.

Lodging/Meeting Rooms and Airfare/Spouse Airfare

With the exception of the Director fees, the majority of costs associated with the Board were Board-related travel expenses, primarily lodging and airfare, including airfare costs for spousal travel. During the period 1998 – 2007, 39% of the total Director expenses were lodging-related, with 11%

related to airfare and 5% related to airfare for Director spouses. Lodging, airfare, and spousal airfare costs incurred by PEC on behalf of the Directors are summarized below:

Summary of Director Airfare, Spouse Airfare and Lodging Expenses for 1998 - 2007

Expense Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Lodging	$47,514	$40,976	$67,372	$91,923	$76,321	$61,753	$71,773	$70,845	$96,665	$103,071	$728,214	71%
Airfare	21,636	31,789	19,814	7,313	5,697	40,836	25,731	22,155	23,741	10,709	209,419	20%
Spouse Airfare	-	5,092	11,836	2,540	9,462	25,058	12,464	11,162	14,042	3,450	95,103	9%
Total Expenses	**$69,150**	**$77,857**	**$99,021**	**$101,776**	**$91,479**	**$127,647**	**$109,967**	**$104,161**	**$134,449**	**$117,231**	**$1,032,737**	**100%**

The vast majority of the lodging and airfare expenditures appear related to various conferences and workshops attended by the Directors each year. Based on information obtained during the course of the investigation, the Directors routinely participated in various conferences held by the NRECA, as well as conferences held by Texas Electric Cooperatives ("TEC"), the state-wide trade association for Texas cooperatives. PEC was also a founding member in the Association of Large Distribution Cooperatives ("ALDC"), which was a separate group of electric cooperatives consisting primarily of the largest electric cooperatives in the United States. In addition, throughout much of the period under investigation, PEC routinely held off-site workshops for the Directors that were outside the normal Board meeting process.

Board members were also encouraged to participate in various trade association-offered training courses (e.g., TEC, NRECA). PEC has historically compensated Board members for attendance at such training sessions, as well as paid for the cost of the course and course materials. However, a Board member's participation, as well as the decision as to what courses to participate in, has been typically left up to the discretion of the respective individual Board members.

The Director workshops appear to have averaged about two per year, with the exception of 2007 when five workshops were held (reportedly as a result of the class action lawsuit). The Board workshops were typically held at remote locations with the majority appearing to take place in San Antonio at the Westin Riverwalk hotel.

For purposes of our analysis, we evaluated the dates and, if available, the indicated purpose for the lodging and airfare expenses in relation to the various meetings and conferences believed to have been attended by the Directors. The relevant conferences, meetings and workshops, and their respective dates, were identified through a combination of sources, including underlying invoices, copies of Director calendars and meeting agendas, and various other internal correspondence. Based on our analysis, almost all of the lodging and airfare expenses evaluated in connection with the Directors appear to have been in relation to the various meetings, conferences and workshops identified. A table summarizing the expenditures relative to the corresponding meeting, conference or workshop is provided below:

Summary of Director Airfare, Spouse Airfare and Lodging Expenses by Business Purpose for 1998 - 2007												
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
NRECA Annual Meeting	$16,253	$10,549	$38,967	$26,279	$34,373	$26,543	$26,101	$33,514	$36,953	$16,533	$266,064	26%
NRECA Regional Meeting	9,064	15,683	14,804	21,977	1,395	11,658	31,101	30,500	9,582	4,152	149,916	15%
NRECA Director's Conference	2,519	8,162	10,093	19,745	9,290	9,017	(2,945)	18,876	17,880	30,198	122,834	12%
NRECA Summer School	497	1,725	21,882	11,269	15,755	-	5,667	13,576	35,133	15,127	120,631	12%
PEC Director's Workshop	-	-	2,240	6,228	15,600	7,967	10,090	6,409	20,649	38,845	108,028	10%
ALDC Meeting	-	-	-	-	8,906	64,010	31,578	-	-	-	104,494	10%
TEC Annual Meeting	12,520	8,360	9,536	16,227	7,676	4,791	9,642	-	4,680	-	73,431	7%
TEC Director's Conference	-	-	-	-	2,097	1,548	2,092	1,286	4,431	5,032	16,486	2%
Uncategorized / Other	28,297	33,377	1,500	50	(3,611)	2,113	(3,358)	-	5,141	7,344	70,853	7%
Total Allocated Expenses	**$69,150**	**$77,857**	**$99,021**	**$101,776**	**$91,479**	**$127,647**	**$109,967**	**$104,161**	**$134,449**	**$117,231**	**$1,032,738**	**100%**

A list of lodging-related credit card expenses reconciled to various conferences, meetings and workshops is provided in Exhibit 24. In addition, a schedule summarizing the reconciliation of total Director expenses evaluated to various business-related purposes is provided in Exhibit 25.

Separately, we also evaluated certain of the large airfare and hotel expenditures paid by PEC and booked as expenses related to two or more Directors as a group. It is important to note that the vast majority of lodging and airfare expenses, whether for individual or group use, were booked directly by PEC, and not individually by the Directors. In many cases, PEC's practice was that an inquiry would be made of the Directors as to their plans to participate in upcoming meetings, conferences and workshops, with little additional detail being provided to the Director[s] as to the selected hotel.

We analyzed over 330 roundtrip or one-way flight segments by Directors and their spouses during the period 1998 – 2007.[322] Included within these data were flights identified for the spouses of certain of the Directors. Of the flights evaluated, the large majority appear to have been standard coach or economy fare flights. Less than 10 of the flights analyzed appear to have been business or first-class fare. Of the business or first class flights identified, these were isolated to just two different conferences (NRECA and ALDC) for which several Directors and their spouses appear to have traveled on business or first-class fares.

With regard to spouse airfare, it is our understanding that spouses were routinely invited by PEC's former General Manager to certain conferences each year, namely the NRECA Annual Meeting, and that spouse attendance at such meetings was not uncommon. We identified over 120 flights for various spouse travel that were paid for by PEC during the period 1998 – 2007 (a full one-third of all Director-related flights). Certain spouses routinely traveled with the Directors to the various NRECA Director's Conferences, Annual Meetings and Regional Meetings. Not all Directors included their spouses in out-of-town travel.

Various lodging expenses were also evaluated. As noted above, Directors did not have a per-diem rate guideline for lodging, and in most instances Directors typically were not involved in the booking and reservation process for hotels. As with the airfare, the lodging expenses for the Board appear

[322] Various credit card expenses reviewed for the investigation are classified as "uncategorized" due to the unavailability of detailed credit card statements to ascertain the type of expense. Many appear to be airfare-related. In addition, limited invoices were available to support the credit card statements. As a result, we relied on information from the credit card statements to identify the airfare class, where possible.

almost entirely related to the various meetings, conferences and workshops attended. While in some instances the lodging choice was pre-determined by the meeting or conference site, in many instances PEC appears to have selected different lodging, including more prestigious and expensive lodging, than that of the general meeting or conference participants. An example of the various lodging expenses and the corresponding meeting, conference and/or workshop is summarized below.

Summary of Select Direct Billed Director Lodging Expenses for 1998 - 2007		
Lodging/Hotel	**Amount**	**Dates**
NRECA Annual Meetings		
Hyatt Regency Grand Cypress (Orlando)	$ 24,868	March 2000
Hotel Adolphus (Dallas)	33,304	March 2002
NRECA Regional Meetings		
Ritz-Carlton (Phoenix)	11,633	July 1999, Oct. 2005
The Westin Riverwalk (San Antonio)	21,977	Sep. 2001
TEC Annual Meetings		
Renaissance Austin Hotel	24,569	Aug. 1999, Aug. 2001
NRECA Summer School		
Mission Point Resort (Mackinac Island)	10,575	July 2000
Big Sky & Ski Resort (Big Sky, MT)	10,634	Aug. 2001
NRECA Director's Conferences		
Paris Las Vegas	3,883	Feb. 2000
Marriott Rivercenter (San Antonio)	13,554	Feb. 2001

Meals and Entertainment

The Directors also did not appear to have a per-diem rate set by the cooperative for meals or other expenditures. Directors appear to have been most frequently reimbursed for the actual expenses incurred, or these expenses were paid directly by PEC on their behalf. Those meal expenses incurred directly by the Directors and reimbursed through their expense vouchers did not appear excessive or outside reasonable expectations given the various Board meetings, conferences and workshops attended by the Directors, and these reimbursements may not have been inconsistent with amounts Directors would have received under a daily per diem for meals.

The significant meal-related expenses associated with the Directors were the expenses incurred through the PEC-issued credit cards, which were also used to pay for various group meals at the referenced meetings, conferences and workshops. As with the lodging and airfare, many of the significant meal-related expenditures seem to have been events coordinated primarily by PEC's former General Manager, rather than Board-coordinated events.

Based on our analysis, we identified 18 such apparent group meals at various well-known high-end restaurants such as Morton's of Chicago and The Palm Restaurant, as well as local area restaurants such as The Fig Tree and Biga on the Banks in San Antonio, Texas. In total, these 18 meals accounted for in excess of $48,000 in Director expenses, which was over 35% of the total meal-related Director expenses.

Detail of Meals from Credit Card Expenses in GL Account 835 Greater than $1,000 for 1998 - 2007

Date	Vendor	Amount	Destination/ Location	Business Purpose
2/12/2001	Morton's of Chicago	$ 3,692.52	San Antonio	Director's Dinner (NRECA Conference)
9/24/2001	Morton's of Chicago	2,528.30	San Antonio	Director's Dinner (NRECA Conference)
9/26/2001	Palm Restaurant	2,508.20	San Antonio	Board Workshop/NRECA Meeting
4/11/2002	Palm Restaurant	2,904.60	San Antonio	Board Workshop/Directors Dinner
10/2/2002	Palm Restaurant	4,868.08	San Antonio	Board Workshop/Directors Dinner
3/3/2003	Palm Restaurant	1,748.61	Nashville	NRECA Directors Meeting
9/11/2003	Morton's of Chicago	1,921.44	San Antonio	Board Workshop/Directors Dinner
11/4/2003	Anasazi Restaurant	1,591.20	Santa Fe	NRECA Regional Meeting
12/11/2003	Horseshoe Bay Resort & Co.	2,880.87	Horseshoe Bay	Board/Managers Holiday Party
12/11/2003	Horseshoe Bay Resort & Co.	2,880.87	Horseshoe Bay	Board/Managers Holiday Party
10/6/2004	Morton's of Chicago	2,099.75	Minneapolis	ALDC Meeting
11/2/2004	Morton's of Chicago	1,684.86	Clayton, Missouri	NRECA Regional Meeting
12/21/2004	Horseshoe Bay Resort & Co	2,624.06	Horseshoe Bay	Board/Managers Holiday Party
11/1/2005	Capital Grille	1,883.93	Phoenix	Director's Dinner (NRECA Conference)
4/20/2006	Fig Tree	2,176.40	San Antonio	Board Workshop/Directors Dinner
3/29/2007	Morton's of Chicago	3,525.50	San Antonio	Board Workshop/Directors Dinner
8/2/2007	Biga on the Banks Banquet	3,272.66	San Antonio	Board Workshop/Directors Dinner
9/20/2007	Biga on the Banks Banquet	3,293.58	San Antonio	Board Workshop/Directors Dinner
Total		**$ 48,085.43**		

Mileage

One of the largest categories of Director Expense Voucher reimbursements was for automobile mileage, which is within the scope of reimbursement for Directors under the PEC Bylaws (i.e., "reasonable expenses of attendance…"). The investigation found that the dollar value of mileage-related reimbursements increased significantly over the years (without a significant change in Board composition); however, the federally approved IRS mileage reimbursement rate also significantly increased during the same time period (from 32.5 cents per mile in 1998 to 48.5 cents per mile in 2007). Adjusting for these rate differences, there do not appear to have been any significant or anomalous changes in mileage or mileage reimbursement during the period under investigation.

Other Expenses

Various other expenditures were attributed to the Directors as well, including photography and floral costs, among others. However, most of the expenditures were not significant and Navigant Consulting's review did not raise any concerns regarding the nature of the expenditures. Examples of these expenditures include the following:

Summary of Select Miscellaneous Expenses from 1998 - 2007 (GL Acct. # 835)			
Date	**Vendor**	**Amount**	**Business Purpose**
11/10/1998	Vandivier Photographer	$ 1,933.30	Board Photographs
11/10/1998	Vandivier Photographer	547.50	Board Photographs
1/14/1999	Cattleman's National Bank	2,841.63	Bellagio Hotel (cashier's check)
11/14/2000	Scarbrough, Medlin & Assoc.	5,901.00	D&O Insurance - Kimble EC
5/20/2002	Carey/Transco Austin	1,009.12	Bus Transportation
6/5/2002	Morton Falls Publishing Co.	340.00	Obituary - A.W. Moursund
6/27/2002	Blanco Floral & Gift Shop	83.50	Bereavement Arrangements
11/6/2002	A B C Blind & Drapery Company	984.00	Office Furniture - Shades
1/25/2005	Ticket Master: Celine Dion	1,920.50	Entertainment at NRECA Conf.
3/20/2006	Blanco Floral & Gift Shop	104.00	Bereavement Arrangements
Total		**$ 15,664.55**	

Of these expenditures, a few items were entertainment-related, one being the purchase of tickets to a Celine Dion concert in the amount of $1,920. The concert was apparently attended by a group of Directors in conjunction with an NRECA annual meeting held in Las Vegas in 2005. In addition, a number of expenditures to Casino Knights, Inc. were identified. Casino Knights, Inc. is a party gaming supply company that provides setups for corporate casino nights. A summary of the expenses evaluated is included in the table below. No other significant concert or entertainment-related expenses were identified.

Summary of Director Expenses Related to Casino Knights, Inc. for 2002 - 2007							
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**
Casino Knights, Inc.	$ 535	$ 1,125	$ 490	$ 250	$ 245	$ 255	$ 2,900

C. Observations and Findings

1. No Established Policy and Procedures

As discussed above, Navigant Consulting did not identify any formal Director expense policy or even informal/ad hoc rules or guidelines regarding the amount and appropriateness of expenses that could be incurred by, or on behalf of, the Board. For Directors, PEC had no pre-determined spending limits, expense levels or ranges, requirements for expenditure authorization or approval, nor established per diem rates to set a benchmark for reasonable and necessary expenditures.

2. Limited Audit/Review Process

In addition to the lack of a defined expense policy, PEC appears to have had only a limited Board review and/or audit function or questioning of expenses incurred by the Directors. Based on our review of expense voucher records, we discovered no situation in which an expense submitted through the expense voucher process appears to have been questioned or denied. In addition, the PEC Finance Manager and his department had only limited access to both the Board's expense reimbursement procedure and the Director-controlled bank account. This insulation of the expense reimbursement process for the Board was apparently a long-standing separation supported by the former General Manager.

3. Lack of Reporting

In addition to the limited transparency into expenses incurred by the Board through the expense voucher process, PEC appears to have had no reporting mechanism for keeping either the Board or PEC Senior Management informed of the types and amounts of expenditures being incurred by, or on behalf of, the Board. While Board-related fees and expenditures paid through PEC's accounts payable process were tracked in PEC's general ledger, detailed credit card expenditures were tracked separately. In addition, regardless of the availability of information from PEC's general ledger, PEC financial management had no reporting mechanism to provide information to either the Board or Senior Management.

4. Expense Guidance Set Primarily by Management

While the lack of transparency and reporting on Director fees and expenses is of concern, especially in relation to the Board-controlled expense account, no significant abuse of the expenditures reimbursed through the Directors' Expense Vouchers appears to have occurred during the period under investigation. The majority of significant lodging, airfare and meal-related expenditures, including a majority of the expenditures questioned prior to the investigation as excessive, appear to have been controlled and paid for by PEC on behalf of the Directors. In many respects, it appears that the Directors simply followed the lead established by the former General Manager.

5. Evaluation of Expenses under a Reasonable and Necessary Standard

With the exception of the Board's participation in various meals and travel-related expenses described above, we have identified no evidence that any individual Director derived personal profit or advantage at the expense of the Cooperative through business dealings. The vast majority of the expenses reimbursed to the Directors or incurred on their behalf appear to have been in relation to various Cooperative-related meetings, conferences and workshops attended by the Directors. Nevertheless, while most of the decisions regarding higher-end hotels, airfare and large group meals at higher-end restaurants, as well as the Celine Dion concert tickets, appear to have been decisions made primarily by PEC former Senior Management, the Directors were willing participants and the beneficiaries of many of these expenditures.

It is our assessment that the actions of the Directors appear generally to have been taken with the intent of benefiting the interests of the Cooperative. However, the Board appears to have exercised little or no oversight over the policy governing the travel-related expenses that have raised significant questions, even though they received direct benefits from these expenses.

In evaluating PEC Director expense reimbursements, the distinction between expenses deemed reasonable and necessary (or as provided for in the applicable statute "actually and necessarily incurred") as opposed to excessive is largely subjective. In addition, there was no provision in the

PEC Bylaws or policies and procedures that expressly precluded the Board from incurring these types of expenses. However, while reasonable explanations exist for most of the expenditures, in reality the expense practices at PEC and on behalf of the Board went largely unchecked. In addition, without adequate reporting, the Directors were likely left with only a vague understanding as to the magnitude of the expenses incurred on their behalf.

The Board has the authority and the obligation to make and adopt rules for the management, administration and regulation of the business affairs of the Cooperative. With respect to Director expenses in particular, the Cooperative's bylaws reference reimbursement of "reasonable expenses for meetings other than Board meetings" as allowed by resolution of the Board, but no such resolutions were discovered in the course of the investigation. Hence, it could be stated that the Directors did not provide meaningful oversight, nor effectively implement controls to ensure that expenditures did not exceed levels that were in the best interests of the Cooperative's members.

D. Recommendations

Navigant Consulting suggests a number of policy related recommendations to improve the effectiveness and oversight of the Board's expenses and expense reimbursement process.

Travel Expense Reimbursement Policy

- Pursuant to allegations and concerns raised regarding former Senior Management and Board expenditures, at the direction of the new PEC General Manager, PEC instituted a *Travel Expense Reimbursement Policy* applicable to both PEC employees and the Board.[323] The expense policy was specifically targeted at travel involving an overnight stay and/or airline travel, with the remaining expense reimbursement procedures for mileage, meals and other incidentals handled through a reimbursement of actual expenses incurred. Navigant Consulting considers the new PEC policy to be appropriate.

- The new policy establishes specific guidelines as to when, and for whom, prior authorization is required for expenditures; guidelines allowing for travel advances (when necessary, but otherwise discouraged), and guidelines establishing baseline airfare, lodging, and meal and incidental expenses. Airfare is restricted to coach or equivalent airfare through discount or customary standard airlines. Lodging expenses are limited to room rates that "should normally not exceed" $250 per night. Meals and incidental expenses are limited to $60 per day (per diem), with required percentage adjustments on days of travel.

- In addition, PEC's new *Travel Expense Reimbursement Policy* specifically excludes reimbursement of expenses for spouse, family or others accompanying the business traveler.

[323] Travel Expense Reimbursement Policy, Pedernales Electric Cooperative, Inc. Board, adopted March 17, 2008. Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 17, 2008.

Directors' Bank Account

- The use of the Director-controlled bank account was terminated in December 2007 and the account was closed on August 1, 2008. Navigant Consulting considers the termination of the Director expense account to be appropriate.[324]

- Currently, all of the Director expenses submitted for reimbursement through the Directors Expense Vouchers are handled through the PEC Accounts Payable controlled disbursement account. Under these procedures, the PEC Finance Department now has a role in connection with Director expenses for the first time, a change we also believe was appropriate.

Audit Committee Review Process

- The new expense reimbursement policy requires the Board Expense Audit Committee to review and approve Board-related expenditures, including responsibility for verifying that the stated purpose of travel is valid and related to official Cooperative business, that expenditures are in accordance with the newly established policy, and that required backup support documentation has been provided and that it is accurate and complete. It is recommended that the Board's Expense Audit Committee, through appropriate delegation to the Cooperative's CFO, establish specific guidelines for the review, identification and verification of expense items submitted for reimbursement.

Expense Reporting – Management and Board Reports

- While consolidating Director expense payments and reimbursements through the Accounts Payable department provides an added degree of transparency, especially in relation to the Board-reimbursed expenditures, the lack of periodic reporting on Board fees and expenditures to the General Manager and Board Audit Committee means that these entities have little access to information necessary to evaluate whether the expense reimbursement policy is being consistently applied and adhered to and whether actual practice is meeting the objectives of the Cooperative and its members. It is recommended that periodic management and Board reporting be prepared to gauge Board fees and expenses in relation to established budgets or forecasts, as well as to ensure that the Board is adhering to both the expense reimbursement policy and providing the anticipated service in connection to its representation of the members.

Expense Budgeting/Forecasting

- Absent any budget to provide a benchmark for expected expenses to be incurred, even adequate expense reporting may not provide the insight required. It is recommended that PEC and the Board undertake to include in the Cooperative's yearly budgeting/forecasting process an estimate of the anticipated expenditures in relation to the Board's service throughout the year. Inherent in such a process is a requirement that the Board define its members' expected participation in various meetings, conferences and workshops, as well as other anticipated events for which expenses would be incurred.

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[324] A review of bank records shows that the account has not received a cash infusion since November 20, 2007 and that no checks have been presented against the account since January 2, 2008.

XVI. Former Senior Management Compensation and Benefits

A. Background

The class action lawsuit and subsequent media and public attention also focused on the compensation of former management of PEC, including Bennie R. Fuelberg, the former General Manager of PEC and Treasurer of the wholly-owned Envision subsidiary; W.W. "Bud" Burnett, formerly employed by PEC in the position of Coordinator, President of the PEC Board, and President of the Envision subsidiary; and Will Dahmann, former Assistant General Manager of PEC. Messrs. Fuelberg, Burnett, and Dahmann all resigned between late 2007 and early 2008.

Throughout the course of the class action lawsuit and ensuing criticisms from Cooperative members, the media, and others, Mr. Fuelberg was under scrutiny for the compensation he received through his annual salary, as well as through a deferred compensation agreement. Questions were also raised regarding Mr. Burnett's compensation in light of his dual role as Board President and an employee of the Cooperative, and circumstances surrounding his retirement benefits and package, as well as whether Mr. Burnett was overpaid relative to the duties he performed for the Cooperative.

B. Work Performed

1. Scope of Work

Included in the scope of Navigant Consulting's work was an evaluation and analysis of historical compensation received by Messrs. Fuelberg, Burnett and Dahmann, and the circumstances surrounding various salary increases, bonus payments and enhanced deferred compensation and retirement plans, respectively.[325] Our efforts focused on Mr. Fuelberg's overall salary and a $375,000 signing bonus received by Mr. Fuelberg in 2004, as well as the approval of a deferred compensation agreement for Mr. Fuelberg, which also occurred in 2004, with an expected value in excess of $2 million. With regard to Mr. Burnett, our efforts focused on his overall salary and periodic bonus payments, as well as an enhanced retirement package provided to Mr. Burnett in 2001.

While our efforts focused on compensation received by Messrs. Fuelberg and Burnett, it was not limited to those individuals. Our work also encompassed a review of Assistant General Manager and Department and District manager salaries across the Cooperative. More specifically, the overall scope of our work included the following:

- Identifying relevant Senior Management, Department and District manager positions and the individuals in those positions during the period 1998 – 2007.

[325] At the time of Navigant Consulting's retention, Jeanell Davis was, and remains, an Assistant General Manager at Pedernales Electric Cooperative, Inc. However, Ms. Davis had been in that position only since May 6, 2006. Given her short tenure, our analysis did not focus on Ms. Davis to the same degree as other Senior Management.

- Identifying relevant information regarding Senior Management compensation and benefits including Form W-2s and various payroll, wage history and/or labor distribution reports.

- Identifying available human resources information including personnel files, employment histories, employment agreements, payroll change authorizations, and time sheets.

- Identifying applicable defined benefit retirement, pension, and deferred compensation plans, as well as health/dental and group life insurance benefit plans.

- Identifying relevant PEC general ledger account(s) in which compensation and bonus payments were booked, and identifying amounts paid to Messrs. Fuelberg, Burnett and Dahmann, and reconciling those amounts to reported compensation on respective Form W-2s.

- Preparing a schedule summarizing the annual salary, bonus, retirement plan contributions and other payments received by Messrs. Fuelberg, Burnett and Dahmann from 1998 – 2008.

- Preparing a detailed chronology and history of circumstances surrounding the changes to the annual salary, bonus, retirement plan contributions and other payments received by Messrs. Fuelberg, Burnett and Dahmann.

- Identifying and evaluating Board resolutions and corresponding authorizations for changes to former Senior Management compensation and benefits.

- Identifying and quantifying other perquisites available to Messrs. Fuelberg, Burnett and Dahmann, including car allowances.

- Searching PEC's accounts payable system by payee for additional payments to former Senior Management and reconciling to reported compensation, benefits and expense amounts.

- Documenting business processes and policies, as well as identifiable benchmarking or compensation studies, used by the Board in determining appropriate compensation.

- Evaluating former Senior Management compensation in comparison to available compensation and salary surveys, as well as historical information identified and used by the Board.

- Analyzing general compensation levels and compensation changes for Department and District managers across the Cooperative, and compare to available benchmarks.

- Reconciling former Senior Management compensation and benefits to IRS Form 990 disclosures.

- Analyzing compensation relative to the perceived value provided by Messrs. Fuelberg, Burnett and Dahmann to the Cooperative.

2. History of PEC Management

The day-to-day operations of the Cooperative are managed by a General Manager, who is selected by the Board to perform the duties of the chief executive officer of the Cooperative. The long-standing former General Manager of the Cooperative, Mr. Fuelberg, was originally selected for that position by the Board in 1976.[326] Mr. Fuelberg served in that capacity until his resignation in early 2008.[327]

Mr. Fuelberg, as General Manager, answered directly to the Board and had direct responsibility for the entire Cooperative, with direct line reporting from the Assistant General Managers and Department Managers. The PEC job description for General Manager states that the "primary purpose of PEC is to serve its consumers," which is the "main priority of every employee."[328] At the time of his resignation, effective March 6, 2008, Mr. Fuelberg had served as the General Manager of PEC for over 30 years. He was initially hired by the Cooperative in 1972 and became the General Manager and effective CEO of the Cooperative in 1976.[329] At the time of his resignation, Mr. Fuelberg's annual salary was $375,000 and he was a participant in a deferred compensation plan with an accrued value (once fully-vested) of $2,050,521.[330,331]

Mr. Burnett was a long-time Director on PEC's Board since 1968 and had served as the President of PEC's Board for over 30 years. Mr. Burnett had also been compensated as a full-time employee of PEC in the position of "Coordinator" for over 20 years (since 1987).[332] The described role of the Coordinator was to "interface with legislative and regulatory bodies," with reporting responsibility directly to the Board.[333] Mr. Burnett served in a dual role as Coordinator and Board President until his resignation from the Coordinator position effective November 30, 2007.[334] Mr. Burnett subsequently resigned as Board President effective January 18, 2008.[335] At the time of his retirement as Coordinator, Mr. Burnett's annual salary was $195,790 and he had a supplemental retirement package.[336]

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[326] Bennie Fuelberg Biographical Information.

[327] Pedernales Electric Cooperative, Inc. Personnel Change Request for Bennie Fuelberg, March 6, 2008.

[328] Pedernales Electric Cooperative, Inc. Job Title: General Manager, revised July 24, 1997.

[329] Pedernales Electric Cooperative, Inc. Payroll Change Request form for Mr. Fuelberg indicates his "Date Employed" as September 1, 1972.

[330] Pedernales Electric Cooperative, Inc. Wage History Report for Bennie Fuelberg indicates Mr. Fuelberg's salary at retirement was $375,000.

[331] Participation Agreement for Bennie Fuelberg, Dated as of December 13, 2004, Under the Pedernales Electric Cooperative, Inc. 2004 457(f) Plan.

[332] Pedernales Electric Cooperative, Inc. Minutes of Meeting of Board of Directors for August 17, 1987.

[333] Pedernales Electric Cooperative, Inc. Board Update for August 17, 1987.

[334] Pedernales Electric Cooperative, Inc. Personnel Change Request for W.W. Burnett, Effective Date: November 30, 2007; Memorandum to Personnel File – W. W. Burnett from Theresa Owens November 9, 2007.

[335] Pedernales Electric Cooperative, Inc. Press Release, January 18, 2008, "Judge Burnett resigns from Pedernales Electric Cooperative, Inc. Board."

[336] Pedernales Electric Cooperative, Inc. Wage History Report for W. W. Burnett.

Mr. Dahmann was employed by PEC for approximately 29 years.[337] However, prior to 1979, Mr. Dahmann worked for over 16 years at the LCRA, an entity which performed all of the daily operating activities on PEC's behalf under contract until those duties were assumed by PEC in the beginning of 1979.[338,339] Based on available records, Mr. Dahmann served as an Assistant District manager to Mr. Fuelberg's father (Ben Fuelberg) in connection with LCRA's efforts to manage PEC's distribution system (until transferred January 1, 1979, as referenced).[340] Upon joining PEC, Mr. Dahmann served as System Operations Chief and Manager of Operations and Engineering Division before assuming the position of PEC's Assistant General Manager in 1992.[341] Mr. Dahmann served as an Assistant General Manager until his retirement effective March 31, 2008.[342,343] At the time of his retirement, Mr. Dahmann's annual salary was $259,709.[344]

3. Overview of Management Compensation Policy/Philosophy

The Board does not appear to have had a defined policy or procedure, nor an established Compensation Committee related to the evaluation of the performance or compensation of PEC's Senior Management. Mr. Fuelberg's compensation was routinely brought before the full Board for consideration each year around the time of the Annual Meeting. However, on several occasions over the past ten years, Mr. Fuelberg's compensation was also reviewed at other times throughout the year, presumably upon a special request by Mr. Fuelberg for additional consideration.

The Board had a standard wage and salary policy for other Cooperative employees. Under the Board's wage and salary policy, employees were assigned a title corresponding to a particular position under the Cooperative's wage scale and classification plan. Each individual employee was then assigned a pay grade, which established the range and midpoint for each employee's potential salary. At least annually, and typically mid-year around the time of the Annual Meeting, the Board would authorize a general cost of living adjustment across the various wage scales. Additional compensation or merit increases would be provided upon promotion or for other purposes deemed appropriate by the General Manager.

Messrs. Burnett and Dahmann both appear to have been subject to the Board's wage and salary policy. However, while Mr. Burnett's position was described as reporting directly to the Board, his compensation does not appear to have been set and/or ratified by the Board since 2001. Annual merit

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[337] Payroll Change Request for Will Dahmann shows New Employment Effective Date of January 1, 1979.

[338] Pedernales Electric Cooperative, Inc. Request for Payroll Change for Will Dahmann shows Date Employed as July 2, 1962.

[339] Payroll Change Request for Will Dahmann, dated December 31, 1978 indicates "In accordance with Minute No. 9558, adopted by the Board, 7-20-78, effective 12-31-78, 12:00 midnight, transferring LCRA employees to Pedernales Electric Cooperative, Inc. payroll."

[340] Request for Payroll Change for Will Dahmann dated November 1, 1974 Submitted by Ben Fuelberg (Dept. Head/Dist. Mgr.) shows "Present Job Classification" as "Assistant District manager."

[341] Payroll change Request for Will Dahmann, dated November 1, 1992 indicates "Present Job Classification Mgr. Opr. & Eng. Div." and "Proposed New Classification Assistant General Manager."

[342] Meeting Minutes of the Board of Directors, Pedernales Electric Cooperative, Inc., March 17, 2008.

[343] Pedernales Electric Cooperative, Inc. Wage History Report for Will Dahmann.

[344] Pedernales Electric Cooperative, Inc. Wage History Report for Will Dahmann.

increases for Mr. Burnett were brought before the Board prior to 2001. After that point, it appears that his salary was set primarily through the wage and salary policy adjustments or directly by Mr. Fuelberg. Mr. Dahmann's salary also appears to have been set by Mr. Fuelberg, with no evidence that it was ever brought before the Board for review.

This process seems to have been applied fairly consistently during the period of our review. However, as would be expected, while Messrs. Dahmann and Burnett were subject to the same wage scale adjustments, their compensation was also adjusted on several occasions outside of the Board's annual wage and salary review process, as was Mr. Fuelberg's.

4. Summary of Total Compensation – Messrs. Fuelberg, Burnett and Dahmann

Messrs. Fuelberg, Burnett and Dahmann each received an annual salary, as well bonuses from the Cooperative in each of the years under review. In addition, Messrs. Fuelberg and Dahmann each received a separate car allowance. All three were eligible for corporate matching of contributions to their 401K account, and they likewise received benefits in the form of health, dental and group term life insurance paid, in part, by the Cooperative (or in whole, as with group term life insurance). Their respective annual compensation from PEC is summarized in the table below:

Summary of Bennie Fuelberg, Will Dahmann and W.W. Burnett's Total Compensation plus Employer 401k Match (1998 - 2008)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total
Bennie Fuelberg	$235,540	$235,752	$251,154	$264,283	$350,514	$381,580	$758,422	$410,734	$409,253	$1,490,123	$593,606	**$5,380,961**
Will Dahmann	173,986	178,341	193,214	209,650	216,244	280,935	291,596	296,636	282,569	290,110	247,580	**2,660,860**
W.W. Burnett	121,673	122,870	136,338	143,949	164,925	190,563	195,244	199,596	201,638	191,633	-	**1,668,430**
Total	**$531,199**	**$536,962**	**$580,705**	**$617,883**	**$731,683**	**$853,078**	**$1,245,262**	**$906,966**	**$893,460**	**$1,971,867**	**$841,186**	**$9,710,251**

5. Total Compensation Received by Mr. Fuelberg

A summary of Mr. Fuelberg's total compensation is provided in the following table and discussed further below:

Summary of Bennie Fuelberg's Compensation (1998 - 2008)

Wage History	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total
Base Pay	$177,600	$177,600	$181,152	$214,704	$297,949	$341,923	$338,734	$359,375	$363,462	$363,462	$78,125	**$2,894,085**
Vacation Pay	-	-	-	-	7,942	-	-	-	-	-	57,692	**65,634**
Holiday Pay	-	-	-	-	7,442	8,077	12,308	8,654	11,538	11,538	-	**59,558**
Eligible 401k Compensation	$177,600	$177,600	$181,152	$214,704	$313,333	$350,000	$351,042	$368,029	$375,000	$375,000	$135,817	**$3,019,277**
Bonus	$51,250	$51,500	$61,450	$31,500	$1,400	$1,500	$377,000	$12,025	$2,900	$3,250	$ -	**$593,775**
Dependent Group Term Life	90	52	52	79	79	79	79	79	152	152	38	**932**
Car Allowance	6,600	6,600	8,500	18,000	18,000	18,000	18,000	18,000	18,000	18,000	3,750	**151,450**
Deferred Compensation Pay	-	-	-	-	-	-	-	-	-	1,071,219	445,852	**1,517,071**
Other Compensation	$57,940	$58,152	$70,002	$49,579	$19,479	$19,579	$395,079	$30,104	$21,052	$1,092,621	$449,640	**$2,263,228**
Total Compensation	**$235,540**	**$235,752**	**$251,154**	**$264,283**	**$332,813**	**$369,579**	**$746,121**	**$398,133**	**$396,052**	**$1,467,621**	**$585,457**	**$5,282,505**
401k match	-	-	-	-	17,701	12,001	12,301	12,601	13,201	22,502	8,149	**98,456**
Total Compensation plus 401k match	**$235,540**	**$235,752**	**$251,154**	**$264,283**	**$350,514**	**$381,580**	**$758,422**	**$410,734**	**$409,253**	**$1,490,123**	**$593,606**	**$5,380,961**

A detailed account of Mr. Fuelberg's total compensation, reconciled to available W-2 Wage and Tax Statements, is provided in Exhibit 26.[345]

Salary and Bonuses

As the newly appointed General Manager of the Cooperative in 1976, Mr. Fuelberg earned less than $30,000 per year.[346] Mr. Fuelberg's salary increased over the years through various Board-authorized cost of living adjustments, merit increases and employment contracts. Mr. Fuelberg's last salary adjustment was in December 2004, when his salary was increased from $350,000 to $375,000 per year. As the time of his retirement, Mr. Fuelberg was being paid an annual salary of $375,000.[347]

Significant increases in Mr. Fuelberg's compensation occurred in 1988, 1994, 2001, 2002 and 2004. In December 1987, Mr. Fuelberg's annual salary was increased over 40% from less than $90,000 per year to $125,000 by resolution of the Board.[348] In July 1994, also by Board resolution, Mr. Fuelberg's salary was increased from $139,256 to $177,590, an approximate 28% increase. Mr. Fuelberg also entered into an apparent employment contract with the Cooperative in 1994 and was authorized a one-time bonus payment of $175,000.[349] Mr. Fuelberg appears to have entered into another employment agreement with the Cooperative in 1997, under which he was paid a one-time lump sum bonus of $225,000.[350] No salary adjustment appears to have been associated with this contract. Neither the 1994 nor 1997 contracts have been identified in PEC's records.

The most substantive changes to Mr. Fuelberg's compensation occurred in the 2001/2002 time period when Mr. Fuelberg's salary effectively doubled from $184,704 per year at the beginning of July 2001 to $350,000 per year at the beginning of September 2002. The increase occurred through several steps, including a conversion of periodic bonuses received by Mr. Fuelberg into salary, as well as several merit increases. Mr. Fuelberg's compensation and changes to his compensation during the 2001/2002 time period are summarized below:

[345] W-2 Wage and Tax Statements covering employee wages prior to 2001 were not retained by Pedernales Electric Cooperative, Inc. As discovered during the investigation, W-2 forms covering the period 1997 – 2001 were apparently destroyed pursuant to the Cooperative's document retention policy in early 2007.

[346] Pedernales Electric Cooperative, Inc. Payroll Change Request for Bennie R. Fuelberg dated December 1978 indicates that Mr. Fuelberg received a wage adjustment on January 1, 1978 bringing his salary to $2,400 per month, or $30,000 per year. It is assumed that his salary prior to this January 1, 1978 adjustment was lower.

[347] Pedernales Electric Cooperative, Inc. Wage History Report for Bennie Fuelberg.

[348] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 21, 1987.

[349] Excerpt from Minutes of the Special Organizational Meeting of Board of Directors of the Pedernales Electric Cooperative, Inc. Held on June 18, 1994. Also, Pedernales Electric Cooperative, Inc. Wage History Report for Bennie Fuelberg.

[350] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 15, 1997.

Summary of Changes in Bennie Fuelberg's Compensation (2001 - 2002)				
	Effective Date	**Change**	**Salary**	**% Change**
Beginning Salary	**1/1/2001**	**$ -**	**$184,704**	**-**
Merit Increase	7/1/2001	60,008	244,712	32.5%
Merit Increase	1/11/2002	50,288	295,000	20.5%
Merit Increase	9/1/2002	55,000	350,000	18.6%
Ending Salary	**12/31/2002**	**$165,296**	**$350,000**	**89.5%**

In September 2001, the Board approved a resolution agreeing to increase the monthly salary and retainer respectively, of Messrs. Fuelberg, Burnett and General Counsel Moursund by $5,000 per month.[351] The salary/retainer increase was described as payment to replace, and in lieu of, the semi-annual bonus payments received by each. The resolution was made retroactive to July 1, 2001. In effect, Messrs. Fuelberg, Moursund and Burnett each received a $60,000 raise through this resolution. However, their total compensation did not change from previous years, as each had received $50,000 – $60,000 in total bonus payments in each of two prior years.[352]

Messrs. Fuelberg, Burnett and Moursund each had received semi-annual bonuses from the Board for a number of years (since 1994/1995), typically one at the time of the Annual Meeting in June and a second at year-end in December. In effect, the Board treated these bonuses as part of each individual's compensation, in that these bonuses were routinely agreed to without adjustment. Each individual was paid two $25,000 bonuses in 1998 and 1999. The bonus amount then increased to $30,000 in 2000 and the first half of 2001. With the September 2001 resolution, the Board essentially acknowledged that these payments had become an immutable right rather than a merit based reward as they had originally been conceived.

Later that year, in December 2001, the Board provided another merit increase to Mr. Fuelberg that increased his annual salary from approximately $245,000 to $295,000.[353] Less than 9 months later, the Board authorized an additional $55,000 increase in Mr. Fuelberg's salary to $350,000.[354] In total, Mr. Fuelberg's salary increased over 40% in a 9-month window from January to September 2002,

[351] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., September 17, 2001.

[352] Each individual received two $25,000 bonuses in 1999: Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 19, 1999; Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 13, 1999. Note, the December 1999 document resolves that the three individuals "each be given the same bonus as last year." A review of the Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 14, 1998 also indicates that the three "each be given the same bonus as last year." The amount is specified as $25,000 in Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 15, 1997. The bonuses were raised to $30,000 in 2000: Resolutions, Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 17, 2000; Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 11, 2000. Note, the December 2000 document resolves that the three individuals "each be given the same bonus as they received in June."

[353] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc. for December 17, 2001.

[354] Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 19, 2002.

increases which came on top of the conversion of his routine annual bonuses (June and December) to salary in September 2001.

In 2004, Mr. Fuelberg executed a three-year employment agreement (i.e., "Retention Agreement") with PEC that increased his salary from $350,000 per year to $375,000. Included with the execution of the retention agreement was a lump sum "sign-on bonus" of $375,000.[355] In addition, Mr. Fuelberg was allowed to participate in a deferred compensation plan ("457(f) Plan") created by PEC for his benefit, with an accrued (and fully-vested) value to Mr. Fuelberg of $2,050,521. The 457(f) Plan for Mr. Fuelberg had a six-year vesting schedule, with the first 50% vesting occurring at the beginning of his third year under the plan.[356]

The 2004 employment agreement appears to have been signed upon the expiration of a previous contract between Mr. Fuelberg and PEC. This earlier contract was apparently entered into in December 1997 and which extended through September 1, 2004. Mr. Fuelberg's salary does not appear to have been increased in relation to the 1997 contract, but he was paid a one-time bonus of $225,000 upon agreeing to the contract, as described. The 1997 employment contract has not been identified in PEC's records.

After receiving the raise in 2004 pursuant to his execution of the 2004 retention agreement, Mr. Fuelberg's salary remained constant through the time of his resignation in 2008.

Deferred Compensation and Defined Benefit Pension Plans

As described, Mr. Fuelberg also entered into a deferred compensation agreement with the Cooperative at the time of his 2004 retention agreement. The plan provided for an accrued benefit to Mr. Fuelberg of approximately $2,050,521, which would vest in increments upon an outlined vesting schedule. The plan allowed for 50% vesting upon three years under the plan, with incremental vesting (70%, 90% and 100%) in years four, five and six under the plan.

PEC's defined benefit retirement plan is a qualified plan under IRS guidelines and is subject to certain salary limitations when calculating a participant's retirement benefits. Mr. Fuelberg's compensation exceeded the qualified plan limit for a number of years and it is our understanding that the deferred compensation plan was developed pursuant to Mr. Fuelberg's request to address this limitation. The accrued benefit amount of $2,050,521 was calculated as the difference between Mr. Fuelberg's projected retirement benefits considering Mr. Fuelberg's salary that qualified under the IRS guidelines and his full salary.

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[355] Retention Agreement Dated as of December 13, 2004 between Pedernales Electric Cooperative, Inc. and Bennie Fuelberg.

[356] Fuelberg's ability to participate in the 457(f) Plan is specified as a "Fringe Benefit" in the Retention Agreement (cited above). The 457(f) Plan is defined in the Pedernales Electric Cooperative, Inc. 2004 457(f) Plan Dated as of December 13, 2004 The value of this plan ($2,050,521.60) and the vesting schedule is specified in the Participation Agreement for Bennie Fuelberg Dated as of December 13, 2004 Under the Pedernales Electric Cooperative, Inc. 2004 457(f) Plan.

Mr. Fuelberg became 50% vested in the plan on January 31, 2007, and received a payout from the plan in July 2007 of $1,071,219.[357] Mr. Fuelberg vested in an additional amount as of January 31, 2008 and received a payout under the plan of $455,852 in July 2008.[358] The plan was terminated in October 2008 and the remaining trust assets were returned to PEC.[359,360]

Mr. Fuelberg also participated in PEC's Defined Benefit Pension Plan. As of April 1, 2008, Mr. Fuelberg began receiving monthly payments of $12,638.53 from that plan, amounts payable to Mr. Fuelberg until his, or his wife's death, or until March 1, 2018, whichever occurs latest.[361,362]

Car Allowance

Mr. Fuelberg also received a car allowance from the Cooperative. PEC established a car allowance in June 1994, applicable to all PEC managers. Pursuant to the car allowance policy, each manager had the option of receiving a monthly car allowance or continuing to drive a Cooperative vehicle. Mr. Fuelberg's initial allowance was set at $550/month and the manager's initial allowance was set at $425/month.[363] It was subsequently increased by Board resolution dated October 23, 2000 to $1,500 per month (effective November 1, 2000).[364]

Cooper Clinic

In addition to the various forms of compensation and benefits described above, Mr. Fuelberg also received physical examinations paid for by PEC from the Cooper Clinic, a highly-regarded clinic outside of Dallas, Texas specializing in preventive medicine. Mr. Fuelberg received physicals in 2003 and 2007, with his wife accompanying him in 2003. The total cost of the physicals was $10,487.

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[357] Letter to Dick Miller, Northern Trust Bank from Michel E. Vollmer, Pedernales Electric Cooperative, Inc. Financial Manager, and Theresa M. Owens, Pedernales Electric Cooperative, Inc. Human Resources Manager, July 16, 2007.

[358] Memorandum to Juan Garza from Michael E. Vollmer and Theresa M. Owens, Re: Final Distribution from Pedernales Electric Cooperative, Inc. 2004 457(f) Plan, July 17, 2008.

[359] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 20, 2008.

[360] Letter from R.B. Felps, Board President, Pedernales Electric Cooperative, Inc. to Richard D. Miller, Northern Trust Bank of Texas, N.A., October 20, 2008.

[361] Letter to Ms. Jamie Fertsch, Frost National Bank from Theresa M. Owens, Human Resource Manager, March 3, 2008. The payout schedule is specified in a letter to Ms. Theresa M. Owens, Human Resources Manager, Pedernales Electric Cooperative, Inc. from Ronald W. Tobleman, Rudd and Wisdom, Inc. Consulting Actuaries, January 31, 2008.

[362] Mr. Fuelberg would continue to receive a payment of $12,638.53 each month if he lives past March 1, 2018. However, Mr. Fuelberg's wife would receive a payment of $6,319.27 each month if she lived past March 1, 2018 and Mr. Fuelberg was deceased.

[363] Resolutions, Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 18, 1994. Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 20, 1994.

[364] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 23, 2000.

6. Total Compensation Received by Mr. Burnett

A summary of Mr. Burnett's total compensation is provided in the following table and discussed further below:

Summary of W. W. Burnett's Compensation (1998 - 2007)											
Wage History	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**
Base Pay	$70,533	$71,590	$75,109	$112,620	$151,371	$174,578	$176,403	$176,855	$181,570	$175,146	**$1,365,775**
Holiday Pay	-	-	-	-	3,705	4,141	6,332	4,259	5,742	5,893	**30,072**
Eligible 401k Compensation	$70,533	$71,590	$75,109	$112,620	$155,076	$178,719	$182,735	$181,114	$187,312	$181,038	**$1,395,847**
Bonus	$51,000	$51,200	$61,150	$31,250	$1,150	$1,100	$1,500	$7,464	$3,100	$ -	**$208,914**
Dependent Group Term Life	140	79	79	79	79	152	152	152	152	140	**1,207**
Board Meeting Fees	-	-	-	-	-	-	-	-	-	2,250	**2,250**
Defined Benefit Plan	-	-	-	-	-	-	-	-	-	5,083	**5,083**
Supplemental Retirement	-	-	-	-	-	-	-	-	-	4,895	**4,895**
Other Compensation	$51,140	$51,279	$61,229	$31,329	$1,229	$1,252	$1,652	$7,616	$3,252	$12,368	**$222,348**
Total Compensation	**$121,673**	**$122,870**	**$136,338**	**$143,949**	**$156,306**	**$179,972**	**$184,387**	**$188,730**	**$190,565**	**$181,178**	**$1,605,967**
401k match	-	-	-	-	8,619	10,592	10,856	10,867	11,074	10,455	**62,463**
Total Compensation plus 401k match	$121,673	$122,870	$136,338	$143,949	$164,925	$190,563	$195,244	$199,596	$201,638	$191,633	**$1,668,430**

A detailed account of Mr. Burnett's total compensation, reconciled to available W-2 Wage and Tax Statements, is provided in Exhibit 27.[365]

Salary and Bonuses

Mr. Burnett became a full-time employee of the Cooperative in 1987. Mr. Burnett's retention as Coordinator was approved by Board resolution dated August 17, 1987. His starting annual salary was $60,000.[366] Mr. Burnett's salary increased over the years primarily through various Board-authorized cost of living adjustments consistent with PEC's wage and salary policy, as well as through several significant merit increases. Mr. Burnett's last increase was in July 2007, when his annual salary was increased from $190,080 to $195,790. At the time of his retirement, Mr. Burnett was being paid an annual salary of $195,790.

Over a 13-year period between 1987 and 2000, Mr. Burnett's salary increased 36% from $60,000 to $81,598. These increases occurred routinely in concert with annual changes to PEC's overall employee wage schedule as approved by the Board each year. However, significant increases in Mr. Burnett's compensation occurred in 2001 and 2002.

In 2001, Mr. Burnett received a 76% increase in salary to $143,645.[367] As with Mr. Fuelberg, Mr. Burnett was paid two $25,000 bonuses in 1998 and 1999, bonus amounts which were increased to $30,000 in 2000 and the first half of 2001. However, in September 2001 the Board converted the bonuses paid to Mr. Burnett into salary, as they did for Mr. Fuelberg. However, Mr. Burnett

365 As previously stated, the W-2 Wage and Tax Statements from 2001 and earlier are no longer available.

366 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 17, 1987.

367 Pedernales Electric Cooperative, Inc. Wage History Report for W. W. Burnett. The document indicates that on July 1, 2001, Mr. Burnett received a "Merit Increase" pay increase to $143,644.80 from $81,598.40, a 76.04% increase.

continued to receive bonus payments in accordance with various annual Board resolutions related to bonus payments for employees (e.g., Christmas bonus payments, mid-year bonus payments).

The Board minutes also reflect that Mr. Burnett's retention as Coordinator was routinely brought before the Board each year for review and approval until 2002.[368] However, June 2002 appears to have been the last time Mr. Burnett's position and annual salary was discussed by the Board until July 2007.[369] It is unknown why the Board stopped its annual consideration of Mr. Burnett's position. However, Mr. Fuelberg had a standing authority delegated from the Board to "retain all other employees of the Cooperative at his own discretion."[370]

Apparently pursuant to the authority granted to him by the Board, Mr. Fuelberg significantly adjusted Mr. Burnett's salary in 2002, raising his monthly salary by $2,500 per month, or over 20%, resulting in a $30,000 annual salary adjustment from $146,512 to $176,512.[371] After this 2002 raise, Mr. Burnett's salary increased annually consistent with the Cooperative's general cost of living adjustments provided to employees in the range of between 2 – 3%.

Upon his resignation from the position of Coordinator in November 2007, the only compensation Mr. Burnett received was in connection with the continued service he provided to the Board as Board President, which was consistent with that paid to other Board members. In addition, with the exception of minor holiday pay/bonuses, consistent with other Cooperative employees, Mr. Burnett did not receive any additional bonuses subsequent to 2001 after the adjustment to his salary.

Defined Benefit Pension Plan

Mr. Burnett also participated in PEC's Defined Benefit Pension Plan offered to PEC employees. Mr. Burnett first became eligible to participate in the plan upon his employment as Coordinator in 1987. However, a significant adjustment was made in relation to his plan in 2001. Mr. Fuelberg proposed basing Mr. Burnett's recorded years of participation under the plan on the date Mr. Burnett joined PEC's Board (1968) rather than the date of Mr. Burnett's employment by the Cooperative (1987), despite the fact that Mr. Burnett had was not qualified to participate in the plan during the intervening 19 years.

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368 Resolutions, Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc. for June 20, 1998; Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 19, 1999; Resolutions, Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 17, 2000; Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc. June 16, 2001.

369 Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 15, 2002. Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 16, 2007.

370 This language is included in the Resolutions for June 20, 1998; June 19, 1999; June 17, 2000; and June 16, 2001 cited above, as well as Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 15, 2002.

371 Pedernales Electric Cooperative, Inc. Status Change Form for W.W. Burnett signed by Bennie Fuelberg, Action & Effective Date: September 1, 2002.

This proposal by Mr. Fuelberg was approved by Board resolution dated December 17, 2001.[372] The resolution essentially obligated PEC to make an additional $4,895.05 payment each month to Mr. Burnett, in addition to the $5,083.33 earned based on his actual 1987 hire date. As of December 1, 2007, Mr. Burnett began receiving monthly payments from the Defined Benefit Pension Plan and directly from the Cooperative totaling $9,978.38, which are payable through his or his spouse's remaining lifetime.[373]

Pursuant to PEC policy, Mr. Burnett is also eligible for the continuation of his health and dental insurance, as well as a conversion of the standard $50,000 Group Term Life Insurance policy held on all employees.[374,375]

Car Allowance

Mr. Burnett did not receive a car allowance from the Cooperative.

7. Total Compensation Received by Mr. Dahmann

A summary of Mr. Dahmann's total compensation is provided in the following table and discussed further below:

Summary of Will Dahmann's Compensation (1998 - 2008)

Wage History	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**Total**
Base Pay	$137,025	$141,135	$149,070	$165,432	$187,729	$229,026	$234,000	$234,600	$240,855	$255,296	$70,830	**$2,044,997**
Vacation Pay	-	-	-	-	654	-	-	-	-	-	-	**654**
Holiday Pay	-	-	-	-	5,513	5,445	8,400	5,649	7,617	-	-	**32,625**
Annual Leave	-	-	-	-	-	-	-	-	-	-	39,955	**39,955**
Eligible 401k Compensation	$137,025	$141,135	$149,070	$165,432	$193,896	$234,471	$242,400	$240,249	$248,472	$255,296	$110,785	**$2,118,231**
Bonus	$36,250	$36,500	$43,450	$43,500	$8,900	$31,500	$34,000	$41,270	$18,400	$18,750	$129,854	**$442,374**
Prior Period	-	-	-	-	1,108	177	-	-	-	-	-	**1,285**
Dependent Group Term Life	90	52	79	79	79	79	79	152	152	152	38	**1,033**
Car Allowance	621	654	615	639	627	639	573	549	636	594	255	**6,402**
Other Compensation	$36,961	$37,206	$44,144	$44,218	$10,715	$32,395	$34,652	$41,971	$19,188	$19,496	$130,148	**$451,095**
Total Compensation	**$173,986**	**$178,341**	**$193,214**	**$209,650**	**$204,611**	**$266,866**	**$277,052**	**$282,221**	**$267,660**	**$274,792**	**$240,932**	**$2,569,326**
401k match	-	-	-	-	11,634	14,068	14,544	14,415	14,908	15,318	6,647	**91,534**
Total Compensation plus 401k match	**$173,986**	**$178,341**	**$193,214**	**$209,650**	**$216,244**	**$280,935**	**$291,596**	**$296,636**	**$282,569**	**$290,110**	**$247,580**	**$2,660,860**

A detailed account of Mr. Dahmann's total compensation, reconciled to available W-2 Wage and Tax Statements, is provided in Exhibit 28.[376]

[372] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 17, 2001.

[373] Letter to Ms. Theresa M. Owens, Human Resources Manager, Pedernales Electric Cooperative, Inc. from Ronald W. Tobleman, Rudd and Wisdom, Inc. Consulting Actuaries, November 9, 2007.

[374] Letter to The Honorable Judge W.W. Burnett from Theresa M. Owens, Pedernales Electric Cooperative, Inc. Human Resources Manager, November 12, 2007.

[375] Mr. Burnett received a "Medicare Carve-Out" policy because he was eligible for Medicare.

[376] As previously stated, the W-2 Wage and Tax Statements from 2001 and earlier are no longer available.

Salary and Bonuses

Mr. Dahmann was first retained by PEC on January 1, 1979 through a transfer of services once performed by LCRA on behalf of PEC (e.g., management of PEC's electric distribution system).[377] Mr. Dahmann's base wage rate beginning January 1, 1979 was $21,732 per year.[378]

Mr. Dahmann's salary increased over the years primarily through various Board-authorized cost of living adjustments and merit increases associated with various promotions. Mr. Dahmann received merit increases in his salary in 1994, 2000, 2001 and 2002, consistent with the same years Mr. Fuelberg received significant merit increases. Mr. Dahmann's last salary adjustment was in July 2007 from $252,144 to $259,709, consistent with the Board-authorized cost of living adjustments. At the time of his retirement, Mr. Dahmann was being paid an annual salary of $259,709.[379]

Mr. Dahmann received a significant $24,000 (or 25%) merit increase in salary in 1994. He also received merit increases in 2001 and 2002, with the 2002 merit increases totaling approximately $60,000, for an approximate 35% increase.

Mr. Dahmann also routinely received bonuses from PEC, averaging between $15,000 and $20,000 in 2006 and 2007. As with Messrs. Fuelberg and Burnett, Mr. Dahmann received two to three different bonuses in a given year, including a standard bonus allocation approved by the Board, as well as discretionary bonuses approved by Mr. Fuelberg. During the years from 1998 through 2005, with the exception of 2002, Mr. Dahmann received bonuses ranging from approximately $30,000 to almost $45,000. Mr. Dahmann received a Board approved one-time severance bonus upon his departure on March 31, 2008.[380] The payment was equivalent to one-half his current annual salary, or $129,854.40.

Car Allowance

Mr. Dahmann did not receive a car allowance, but was provided a PEC company vehicle for use during these years.

C. Observations and Findings

1. Mr. Fuelberg's Compensation was Approved by the Board

Mr. Fuelberg's total compensation, including annual bonuses and periodic lump-sum contract payments and merit increases all appear to have been approved by the PEC Board. During the investigation, we found no indication that any of the various components of Mr. Fuelberg's compensation had been instituted without the full knowledge of the Board.

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[377] Payroll Change Request for Will Dahmann, Effective Date December 31, 1978 indicates "In accordance with Minute No. 9558, adopted by the Board, July 20, 1978, effective December 31, 1978, 12:00 midnight, transferring LCRA employees to Pedernales Electric Cooperative, Inc. payroll."

[378] Payroll Change Request for Will Dahmann, Effective Date January 1, 1979 indicates a "New Base Wage Rate" of $1,811 per month, or $21,732 per year.

[379] Pedernales Electric Cooperative, Inc. Wage History Report for Will Dahmann.

[380] Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 17, 2008.

As described above, Mr. Fuelberg apparently had various contracts or employment agreements with PEC over the years including contracts executed in 1994 and 1997, as well as the most recent contract entered into in 2004. While documentation related to the 1994 and 1997 contracts has not been located, the process with regard to Mr. Fuelberg's compensation in relation to his contracts appears to have been relatively consistent, including approval of the associated lump-sum signing bonuses, which were $175,000 in 1994, $225,000 in 1997 and $375,000 in 2004. The Board appears to have been following a procedure established in years past with regard to Mr. Fuelberg's compensation.

Incumbent Board members seated prior to the Cooperative's June 2008 elections who were interviewed as part of the Navigant Consulting investigation continue to staunchly support Mr. Fuelberg's compensation as appropriate remuneration for his efforts in managing the Cooperative and overseeing its growth and success over the years.

2. Questionable Conversion of Bonuses to Salary in 2001

As described above, Messrs. Fuelberg and Burnett were routinely granted bonuses by the Board. Similar bonuses were also typically provided to Mr. Moursund. From at least 1998 through June 2001, each individual was routinely granted a bonus by the Board following the Annual Meeting in June/July and another at year-end, typically at a December Board meeting. These bonuses averaged between $20,000 and $30,000 each payment, providing an additional $50,000 - $60,000 in annual compensation.

The Board members interviewed as part of the investigation have varying recollections of the bonuses provided to Messrs Fuelberg, Burnett, and Dahmann, especially with respect to payments approved for Mr. Burnett. The Board minutes reflecting the Board's approval of these bonuses are vague and non-specific with regard to the bonuses and in many instances fail to list the specific amount that was approved for payment. While Board minutes for corporations are often not reflective of the depth of discussions regarding specific topics covered at a meeting, the consistently vague nature of the information appearing in the PEC Board minutes in relation to bonuses for these individuals may be characterized as unusual.

The practice by which Messrs. Fuelberg, Burnett and Moursund were provided with two separate bonuses each year had existed for a number of years (since 1995). It is unknown why two separate bonus periods were used by the Board. However, often the Board simply resolved that "each be given the same bonus as in past years." This language would often be consistent from one-year to the next, raising the question as to whether the Board members in fact understood what amounts were being paid to Messrs. Fuelberg, Burnett and Moursund.

Of equal concern is the Board's apparent agreement to convert the bonuses received each year by these individuals to salary. The September 2001 Board minutes and resolution accomplishing this adjustment stated the following:[381]

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[381] Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., September 17, 2001.

> *…effective July 1, 2001, the Cooperative's Coordinator W.W. Burnett, General Manager Fuelberg, and General Counsel Moursund will no longer receive semi-annual bonus payments, and their monthly salary or retainer shall be increased by $5,000 per month.*

However, based on interview comments made by Directors, the majority of Board members present at this meeting did not remember either this resolution or the magnitude of compensation fixed by the resolution, particularly as it concerned Mr. Burnett. Many Board members were "shocked" at the amount of total compensation Mr. Burnett was receiving at the point of his resignation in 2007. Many believed him to be earning an amount significantly less than his actual compensation, even though these compensation levels were memorialized in the September 2001 resolution that authorized the substantive increase in his salary.

3. Compensation Adjustments Coincided with Cash from Debt Proceeds

As described, Mr. Fuelberg's compensation increased significantly at certain points in time (i.e., 1988, 1994, 2001 and 2002). Messrs. Burnett and Dahmann also received substantive increases in compensation during some of the same time periods, as did Mr. Moursund through his retainer. The adjustments in compensation appear to have coincided or followed significant injections of cash into PEC through the Cooperative's bond offerings, as well as substantive loans received by PEC through its financings with the Cooperative Finance Corporation ("CFC"). The significant bond or loan proceeds received by PEC over the past twenty years are summarized below:

Summary of Bond and Note Proceeds (1987-2002)

Year	Debt Instrument	Proceeds
1987	Bond	$ 126,000,000
1993	Bond	80,000,000
1995	Bond	135,000,000
1998	Note	80,000,000
2000	Note	60,117,290
2001	Note	36,222,499
2002	Bond (net of note retirement of $171M)	278,644,000

While the exact motivation behind the decisions to substantially increase salaries during these periods has not been identified, it is readily apparent that steps were taken by PEC former Senior Management and the Board to significantly increase compensation levels around the same time as the receipt of the bond and loan proceeds. In addition, it can be observed that the significant cash influx from these financing events obviated any need for PEC to adjust rates, effectively manage the Cooperative's controllable expenses, or take additional steps to ensure sufficient liquidity to cover these expenses along with other cooperative needs in the short term. In many respects, these significant increases in compensation were protected from direct or inadvertent disclosure due to the significant cash cushion existing at the time.

1987 Bond Proceeds

While little is known about the rationale and support for Mr. Fuelberg's (50%) salary increase in 1988, as it is outside the period of our investigation, it occurred following a significant injection of additional debt and cash into the Cooperative. PEC's first bond offering was in September 1987, under which $126 million in funds was raised. A similar correlation can be noted with respect to Mr. Fuelberg's salary increase in 1988, following a period during which both Messrs. Moursund (PEC General Counsel) and Burnett were rewarded with significant compensation arising out of the cash settlement of the Texland matter (discussed elsewhere in the Report), and whereby Mr. Burnett became a full-time employee of the Cooperative, while also serving as Board President. In addition, the Board's compensation was increased in December 1987 from a $200 per diem to a per diem of $500 for attendance at an official voting meeting and a per diem of $250 for all other days spent on Cooperative related business. A table summarizing the compensation increases corresponding to the 1987 bond offering proceeds of $126 million is provided below:

Summary of Compensation Increase and Long-term Debt Issuance (1987 - 1988)

Name	1987	1988	% Change
Bond Proceeds	**$126 M**		
Fuelberg, Bennie	$86,694	$130,000	*50%*

1993 Bond Proceeds

Similar to Mr. Fuelberg's 1988 salary increase, little is known about the rationale and support for the salary increase in 1994. However, it also occurred following a significant injection of additional debt and cash into the Cooperative in 1993 from an $80 million loan from CFC. The Board compensation structure was also increased in 1994 to a per diem of $750 for attendance at an official voting meeting and a per diem of $300 for all other days spent on Cooperative related business.

In addition, the PEC Board authorized an increase in the monthly benefit retired employees received from the Cooperative's Defined Benefit Retirement Plan equal to 2% for each year of service since the date an employee's benefits began. This increase in retirement benefits significantly increased the funding requirements and potential liabilities of the Cooperative for retirees, of whom Mr. Moursund was one of in 1993. A table summarizing the compensation increases corresponding to the 1993 bond offering proceeds of $80 million is provided below:

Summary of Compensation Increases and Long-term Debt Issuance (1993 - 1994)

Name	1993	1994	% Change
Bond Proceeds	**$80 M**		
Fuelberg, Bennie	$139,256	$177,590	*28%*
Dahmann, Will	95,992	119,995	*25%*
Total	$235,248	$297,586	

2000 – 2002 Note and Bond Proceeds

As described, Messrs. Fuelberg, Burnett and Moursund's salaries were increased significantly during 2001 and 2002. These increases generally coincided with significant increases in Board compensation as well as widespread increases in compensation levels across the Cooperative that occurred both in advance of and around the time of the 2002 Bond Offering, pursuant to which PEC realized approximately $279 million in bond proceeds. Mr. Fuelberg also made significant widespread increases in the salaries of various managers in which approximately sixteen different District and Department managers received raises of $24,000 per year in 2002, averaging approximately 30% per manager.

The Board's compensation structure was also adjusted in 2001. Beginning in September 2001, PEC eliminated the per-meeting fee for outside Board activities (i.e., non-voting meetings) in lieu of a fixed monthly fee, which was intended to encompass all other services provided by the Directors outside of regularly scheduled and special-called Board meetings. Prior to the change in 2001, the average annual Director fees (excluding benefits) varied widely from approximately $11,000 to over $20,000 per year, depending on the number of non-voting meetings attended by each Director. However, after the change to the $1,500 per month fixed fee, all Directors were essentially paid the same (averaging approximately $30,000 per year). As a result, both average compensation per Director and total compensation for all of the Directors increased significantly.

The PEC Board also authorized an additional increase in the monthly benefit retired employees received from the Cooperative's Defined Benefit Retirement Plan equal to 2% for each year of service since the last increase in 1994. This increase in retirement benefits increased the funding requirements and potential liabilities of the Cooperative to its retirees. A table summarizing the compensation increases corresponding to the 2000 – 2001 CFC notes and the 2002 bond offering proceeds of $279 million is provided below:

Summary of Compensation Increases and Long-term Debt Issuance (2000 - 2002)

Name	2000	2001	% Change	2001	2002	% Change
Note & Bond Proceeds (Net)	**$60 M**	**$36 M**		**$36 M**	**$279 M**	
Fuelberg, Bennie	$184,704	$244,712	*32%*	$244,712	$350,000	*43%*
Dahmann, Will	160,867	169,998	*6%*	169,998	230,004	*35%*
Burnett, W W	81,598	143,645	*76%*	143,645	176,513	*23%*
A.W. Moursund Retainer	141,264	201,264	*42%*	201,264	201,264	*0%*
Manager Salaries*	1,263,932	1,364,212	*8%*	1,628,161	2,157,706	*33%*
Total	$1,832,366	$2,123,831		$2,387,781	$3,115,487	

* 2001 Manager Salaries totals differ because the percent salary increase was calculated for managers employed during both years of each comparison.

Mr. Fuelberg's timing in seeking raises for himself, Mr. Burnett and Mr. Moursund, as well other Cooperative employees, thus appears opportunistic in relation to the cash cushion provided by cooperative financing events. Even assuming a performance-based or bench-marked justification existed for these increases in compensation (See discussion below), the apparent timing of the compensation adjustments provides the appearance that former Senior Management and the Board was enhancing their compensation at the expense of increased debt to the Cooperative, and under cover of a significant cushion in cash and liquidity.

A relevant factor for the foregoing analysis is that PEC's efforts to source its debt needs through bond offerings, as well as in part through CFC, provided less restricted access to funds than if PEC had pursued loans from the Rural Utility Service ("RUS"), the subsidized funding arm of the Department of Agriculture. Loans through the RUS are strictly controlled and the proceeds are designated to be used primarily for construction and capital improvement, as well as other purposes specifically provided for in the loan guidelines. RUS loans are typically not provided for working capital purposes and would not have been provided in lump sum to PEC for use at its discretion.

4. Basis for the Increased Salary and Bonus Payments

Mr. Fuelberg's and the Board's compensation decisions appear to have been motivated more by cash-on-hand in the Cooperative and by Mr. Fuelberg's individual judgments, than by any objective measure of performance or comparison to industry-wide compensation benchmarks. While the pre-2008 Board members generally acknowledge and continue to defend the amounts paid to Mr. Fuelberg, we have identified little or no empirical evidence used by the Board in justifying its decisions. In each year reviewed, there does not appear to have been any evaluation body, such as a Compensation Committee, tasked with identifying, analyzing and evaluating the appropriate compensation for Messrs. Fuelberg, Burnett and Moursund, nor the establishment of any objective means of evaluating performance against proposed compensation. The Board's decision-making appears to have been largely unsupported by any metrics and primarily based on proposals of the former General Manager. Our review of the historical policies and procedures for compensation identified only limited information used by the Board in support of its decisions. As described, there is limited information (e.g., compensation surveys) in the Board packages and other records related to Mr. Fuelberg's salary increase from $184,704 to $350,000 during the period 2000 – 2002 other than the Board resolutions. In addition, although the Board followed a fairly routine procedure of evaluating compensation for the Cooperative each year around the time of the Annual Meeting, no procedure appears to have been established to provide information to the Board for their evaluation and analysis in advance of those decisions.

In addition to the routine annual reviews, special compensation adjustments were also made in September 2001, September 2002, and September 2004. As discussed above, we have identified no rationale for the adjustment to convert the bonus payments received by Messrs. Fuelberg, Burnett and Moursund to an increase in their salaries and retainer, respectively, in 2001. The adjustment appears to have been initiated by Mr. Fuelberg, rather than pursuant to a Board-directed effort, and we have identified no evidence to support that any reasons for or potential ramifications of such a decision were ever articulated. Prior to this point, the Board appears to have routinely approved sizable bonuses to these individuals, though as noted, often without explicit information regarding the actual dollar effects. While the compensation in the form of bonuses was still essentially at-risk and theoretically subject to (unspecified) performance standards, the conversion of these bonuses to salary status essentially guaranteed the amount of compensation for these managers, a policy that departed from generally recognized practice with regard to executive and senior management compensation.

5. Comparison to Other Cooperative General Managers

In addition to evaluating Mr. Fuelberg's compensation during the period 1998 - 2007, Navigant Consulting also compared the salary and overall compensation received by Mr. Fuelberg to an NRECA compensation survey, as well as other information available with respect to his compensation at various points in time. Notwithstanding the timing of Mr. Fuelberg's salary increases, or apparent lack of Board process and performance evaluation, Mr. Fuelberg's compensation as of 2007, excluding the deferred compensation agreement, does not appear to have been significantly out of line with that of comparably situated senior managers within the industry.

A limited survey performed by Navigant Consulting into the compensation and benefits paid to managers at the largest electric cooperatives in the United States and Texas indicates that Mr. Fuelberg's compensation ($375,000), at least in 2006, was not inconsistent with similar entities' compensation levels. The survey disclosed that at least ten General Managers received in excess of $300,000 per year and three of those received in excess of $400,000 per year.

Likewise, in comparison to a recent compensation survey conducted and published by the NRECA, General Managers in the upper tier of cooperatives ranked by number of consumers served, on average, were reported making in excess of $260,000 per year, with the range being $93,500 to $375,000.[382]

While Navigant Consulting's scope of efforts did not include a detailed comparison of Mr. Fuelberg's compensation to various available surveys and other information over the past ten years, some comparisons were made for these periods. For example, Mr. Fuelberg's annual salary and bonus, again excluding his deferred compensation arrangement, tended to be on par, and typically below, the annual compensation of the former General Managers of LCRA during the corresponding periods. However, Mr. Fuelberg's deferred compensation agreement, executed in 2004, places him significantly above the compensation received by LCRA's former General Managers, as well as above the highest compensation for any of the electric cooperatives we observed.

6. Evaluation of Mr. Burnett's Position as Coordinator

With regard to Mr. Burnett's role at the Cooperative, questions have been raised both internally and externally. As described, in addition to his role as Board President, Mr. Burnett was a full-time employee of the Cooperative for almost twenty years in the position of Coordinator. While it was generally understood that Mr. Burnett's job description was to act as a liaison with various governmental and legislative individuals and entities, neither the Board members nor the PEC Department managers had much understanding of what Mr. Burnett did on a day-to-day basis. While some recall him providing updates regarding his participation in certain outside organizations,

[382] 2008 National Compensation Survey, All Distribution Cooperatives, General Manager/CEO, Copyright © 2008 NRECA.

those recollections are limited and refer primarily to the more distant past. Many Board members appeared to have had limited interaction with Mr. Burnett over the years, other than in connection with Board meetings.

The employees at PEC had even less understanding as to Mr. Burnett's role within the Cooperative. Mr. Burnett did not have an office at PEC, nor did he have a PEC-issued computer. Mr. Burnett also apparently had limited or no interaction with PEC employees other than Mr. Fuelberg. Even the assistants to Messrs. Fuelberg and Dahmann had limited interaction with Mr. Burnett, with this primarily constituting the disposition to him of the package of materials in advance of the regular monthly Board meetings, and travel arrangements.

Various current and former PEC employees and Board members have been critical of Mr. Burnett's role, as well as his level of compensation, generally citing the lack of contribution from Mr. Burnett in relation to his compensation, which many Board members believed to be lower than its actual level. Most individuals interviewed in connection with the investigation, including members of the Board, had no effective comprehension regarding the amount of Mr. Burnett's annual compensation.

While Mr. Burnett did, in fact, appear to have some limited role within the Cooperative, his recruitment as Cooperative Coordinator in 1987 appears to have stemmed from his personal relationship with Mr. Fuelberg and his personal financial situation at the time, rather than as a result of the Cooperative's need for the Coordinator position as described. Regardless of whether Mr. Burnett reported directly to the Board, his efforts and allegiance were to Mr. Fuelberg, and the Board felt it had no alternative but to continue supporting him in his dual positions, although the Board members had an incomplete understanding as to the true level of his compensation by PEC. As discussed above, while the Board was aware of the increase in the retirement benefit for Mr. Burnett in 2001, the Board generally appears to have been unaware of the magnitude of this increase. A number of Board members recall believing the increase to Mr. Burnett's retirement plan was not that significant, but acknowledge that the information they were provided was relatively limited, and came primarily from Mr. Fuelberg.

The Board's failure to take steps to substantively evaluate the performance of Mr. Burnett as a manager reporting directly to them, or indeed to assess the utility to the Cooperative of his function, as well as to insist on accurate information about and to critically evaluate Mr. Burnett's compensation, is an example of the Board's failure to provide effective oversight of Mr. Fuelberg and of the Cooperative. As with a number of other issues, the Board allowed decisions on these matters to be made by their General Manager, Mr. Fuelberg, without substantive input from the Board, and acceded to a status quo that was not in the best interest of PEC or its members.

7. Compensation of District and Department Managers

Mr. Fuelberg had the authority to retain all employees of the Cooperative at his discretion.[383] In addition, by Board resolution in 2002, all managers of the Cooperative were designated as "exempt

[383] Minutes of Special Organizational Meeting, Board of Directors, Pedernales Electric Cooperative, Inc., June 15, 2002.

employees to be compensated at General Manager Fuelberg's discretion."[384] Thus, while compensation of the Cooperative managers was subject to the Board's wage and salary policy and the annual cost of living adjustments prescribed by the Board, Mr. Fuelberg had delegated authority to compensate each manager at his own discretion.

In addition, Mr. Fuelberg was granted the authority to make certain one-time payments (i.e., bonuses or merit increases) to employees at his own discretion. Pursuant to Board resolutions in 1987, 1998 and 2007, Mr. Fuelberg was

> *…authorized to make a one-time payment to an employee of the Cooperative for some exceptionally well done accomplishment...without further authorization from this Board, the amount and circumstances of such 'recognition payment' to be at the sole discretion of General Manager Fuelberg...*[385]

Navigant Consulting reviewed the salary history for each of PEC's District and Department Managers during the period 1998 - 2007. With the exception of the previously described across-the-Board compensation adjustment for all Cooperative managers in 2002, the annual salary adjustments in other years for most managers appear consistent with the wage and salary increases authorized by the Board. Where exceptions were noted as part of our review, we determined that the above-average wage increases were correlated with promotions of the respective individuals.

Navigant Consulting also performed a summary level comparison of the compensation levels of various classes of PEC employees, including District and Department managers, to the NRECA compensation survey previously referenced. While differences were noted, we generally did not observe any salary for a PEC employee below the manager level that was significantly out of line with the range of results reported by the NRECA survey.

However, we did observe that employee compensation at the Manager and Assistant General Manager level at PEC was generally higher than the range of results reported by the NRECA survey. The average Assistant General Manager salary was over 53% higher than the average and 19% higher than the maximum salaries reported in the NRECA survey. The average PEC Manager salary was 49% higher than the average and 12% higher than the maximum Manager's salary reported in the NRECA survey.[386]

As with other comparative assessments of this Report, PEC, as the largest electric distribution cooperative in the United States presents difficulties in providing a reliable and meaningful basis of comparison. Nevertheless, it appears that the salaries of the PEC Assistant General Managers and Managers are on the high side of the comparison data observed.

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[384] Resolutions, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 19, 2002.

[385] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 21, 1987.

[386] 2008 National Compensation Survey, All Distribution Cooperatives, Assistant General Manager, Copyright © 2008 NRECA.

D. Recommendations

Navigant Consulting suggests a number of policy related recommendations to improve the effectiveness and oversight of the Board's and management's evaluation of management compensation.

Compensation Committee

- As noted, the Board did not establish or routinely use any committees, including a Compensation Committee, during the past ten years. Committees are viewed as an important component of any Board's oversight process because they allow for more in-depth research and analysis of particular areas and issues that may not be possible during a regular Board meeting.

- Given the importance of the General Manager/CEO position in an organization, and the importance of being able to periodically evaluate performance and incentivize for a certain level of performance, it is recommended that the Board create a standing Compensation Committee tasked with defining performance measures and routinely evaluating the executive's performance against those metrics.

- It is recommended that the Compensation Committee be comprised of independent Directors only, to ensure that the process of evaluating executive compensation is free from any potential influence on behalf of the executive.

- Further, it is recommended that the Compensation Committee periodically engage the use of independent outside consultants and experts who can provide objective assessments and comparisons to industry-wide compensation trends and surveys.

- It is recommended that the Compensation Committee establish a Charter that clearly defines: its purpose; the breadth of duties delegated to it by the Board, including reviewing Executive compensation; what responsibility, if any, the Compensation Committee has with respect to the annual wage and salary cost of living adjustments; an anticipated meeting schedule; defined performance metrics, and an evaluation process for the General Manager, among others.

- The key elements of an effective Compensation Committee should include the following:

  - » The Compensation Committee should be independent, both in fact and appearance, from the Cooperative's senior management.
  - » The Compensation Committee should formally review all elements of compensation for PEC senior management positions at least annually.
  - » Any changes to the General Manager's compensation and benefits should be reviewed and approved by the full Board, not just the Compensation Committee or Executive Committee.
  - » Any compensation consultant hired to evaluate management compensation should be retained by the full Board.

- » Every few years, an independent qualified compensation expert should be asked to provide an opinion as to the reasonableness of the General Manager's total compensation package.
- » Transparency should be a guiding principle.

Executive Compensation Plan

- While it is beyond our scope of work to provide specific guidance as to the appropriate compensation level for the General Manager, we recommend that the Board develop a compensation policy and practice for the General Manager and perhaps Assistant General Managers that is transparent and reflective of the special nature of PEC as the largest electric cooperative in the United States. Compensation should be both competitive and reasonable.

- It is recommended that this task be undertaken through the Compensation Committee, which should establish an appropriate basis for comparing and benchmarking executive compensation. Chief among the considerations should be the benchmarking to an appropriate group of other cooperatives, public utilities, and investor-owned utilities, taking into consideration the size and complexity of PEC, as well as the significant challenges in managing a significant growth-oriented business whose primary obligation is to serve its members through low rates and reliable service.

- It is also recommended that the Board establish performance metrics for the General Manager, including consideration for the overall short-term and long-term strategic goals of the Cooperative, and an assessment of how effectively the General Manager is moving the Cooperative in that direction.

- In addition, in consideration of this benchmarking, it is recommended that consideration be given to levels of compensation that the members, with an understanding of general compensation practices, would find reasonable.

Delegation of Authority over Other Cooperative Employee Wages

- It is recommended that the Compensation Committee and/or the Board evaluate the authority delegated to the General Manager with regard to discretionary salary and bonus payments. While some discretion is expected and warranted, the Board may want to evaluate setting certain limits, above which Board authorization would be required. In addition, while the Board historically was not presented with any information regarding the annual salaries received by District and Department managers, the Compensation Committee may wish to at least review this information, and any proposed adjustments to it, on an annual basis in conjunction with the General Manager.

Board Review of Public Disclosures

- The amount of compensation and its elements should be clearly reported in filings with the Federal government (i.e., IRS Form 990) and PEC's annual report, and it is recommended that the Board, through the Compensation Committee, should regularly review these filings. In addition, it is recommended that the Board go beyond the minimum requirements for reporting compensation on Form 990 and clearly describe the organization's compensation philosophy, the process used to determine executive pay, and each element of compensation for officers of the Cooperative.

XVII. Former Senior Management Expenses/Expense Reimbursement

A. Background

Throughout the course of the class action lawsuit and as a result of criticisms from Cooperative members, the media and others, questions were raised regarding the expenses reimbursed or paid by the Cooperative on behalf of former Senior Management (i.e., Messrs. Fuelberg, Burnett and Dahmann). Many identified expenses were perceived to have been lavish or excessive and outside the realm of reasonable and necessary expenses appropriately related to the day-to-day management of the Cooperative. The primary expenditures questioned included items for hotels, restaurants and first-class air travel incurred primarily by Mr. Fuelberg. Expenditures in these areas made on behalf of PEC Board members are discussed in a prior section of this Report.

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and evaluating expenses incurred by, or paid on behalf of, former Senior Management during the period 1998 - 2007. Inherent in our efforts was the review and evaluation of the various procedures by which PEC either paid for expenses directly through Cooperative-issued credit cards or reimbursed management for expenses through an expense voucher process. We also attempted to evaluate what policies existed, if any, for the review and determination of whether expenses incurred by management were appropriate and reasonable for payment or reimbursement. More specifically, the scope of our work included the following:

- Identifying and evaluating current and historical travel and expense reimbursement policies and procedures including the use of travel and expense vouchers.

- Evaluating PEC's historical Purchasing Card Program and the issuance of corporate credit cards, as well as the policies and procedures regarding card issuance and procedures for use.

- Identifying Board minutes/resolutions related to expenses and expense reimbursement policies for Senior Management.

- Documenting business processes and procedures established and/or followed regarding expenses and expense reimbursement, including relevant internal controls.

- Identifying relevant PEC General Ledger account(s) where Senior Management-related expense items were coded, including associated expense coding practices.

- Identifying various expense records for former Senior Management including related travel and expense vouchers and credit card statements, as well as underlying support documentation.

- Analyzing accounts payable ("A/P") and check register reports by individual.
- Preparing schedules summarizing former Senior Management expense reimbursements through expense vouchers submitted by individual for the period 1998 - 2007.
- Identifying corporate credit cards used by former Senior Management, including historical statements from PEC and credit card companies, and summarization of card usage and expenses by period for each individual during the period 1998 - 2007.
- To the extent we were able to do so from available data, categorizing expenses by expense type (e.g., lodging, airfare, meals, etc.) and correlation to identifiable business reasons or purposes (e.g., Board meetings, conference attendance, etc.).
- Preparing detailed analysis of larger expenditures including lodging, airfare, spouse airfare, meals and entertainment, and analysis of corresponding purposes for the expenses (e.g., Board workshops, conferences, meetings with ratings agencies, etc.).
- Evaluating former Senior Management expenses relative to their reasonableness and necessity and comparison to general industry expense reimbursement guidelines.
- Benchmarking PEC's expense guidelines and expense reimbursement policies and procedures to general industry guidelines.

2. Expense Reimbursement and Credit Card Usage Policies

Various employees at PEC including former Senior Management and most Department and District managers had the use of a Cooperative purchasing card (i.e., credit card) issued through JP Morgan Chase Bank for business and business travel-related expenses. Cooperative employees could seek reimbursement through an established expense voucher process. Standard policies exist at the Cooperative related to the issuance and use of Cooperative credit cards, as well as the process for reimbursement through the expense voucher process.

The Cooperative's current *Expense Reimbursement Policy* dates back to the beginning of 1991 and was authorized by the Board at the time. Similar to other standard expense reimbursement policies typical among corporations, the policy provides for the reimbursement of "all business related expenses incurred in carrying out work assignments."[387] The policy addresses the types of expenses covered (e.g., hotel, air travel, meals, and other bona fide business expenses, etc.), as well as the required documentation to support the reimbursements made. In tandem with the policy, PEC incorporated the use of both a *Travel Expense Voucher* and a *Business Expense Voucher*, with the latter being for all other "bona fide business expenses incurred by employees in the performance of their official duties with the Cooperative."[388] The current expense voucher process appears to have been placed into practice in early 1991.

[387] Expense Reimbursement Policy, Adopted by Board of Directors on December 17, 1990.
[388] Memorandum from Bennie Fuelberg to All Managers, Re: Expense Reimbursement Forms, February 11, 1991.

The approval of manager expense vouchers appears to have been the responsibility of Mr. Fuelberg until 2003, when that policy was adjusted to require his approval only for expense vouchers in excess of $1,500. However, our review disclosed no such approvals on manager expense vouchers at any dollar level that were dated prior to 2003. Approval of the various forms for employees below manager level was the responsibility of each Department manager.

In addition to the use of the expense voucher forms, PEC had a corporate Purchasing Card program through JP Morgan Chase. The Purchasing Card program provided PEC with a master account and allowed for the issuance of multiple credit cards to various Department and District managers under that account, including former Senior Management, as well as certain other Cooperative employees. The credit card balance was paid each month directly by PEC, rather than by the individual employees.

The current Purchasing Card Procedures appear to date back to at least 1997.[389] The procedures provide general guidelines on card issuance, cancellation, authorized and unauthorized purchases, and the overall responsibilities and limitations of the card user. The procedures also allowed for the establishment of both a monthly dollar limit and a per transaction dollar limit. The general guidelines allowed the use of the purchasing cards for purchases under $1,500.

Each month PEC was sent a master credit card statement from JP Morgan Chase with separate summary statements for each PEC staff member who had been issued a corporate credit card. The separate summary statements were provided to the respective individuals who were then responsible for coding the various expense items incurred by them during the month. Managers were then responsible for approving the credit cards in use by employees in their respective departments, as well as self-approving their own credit card use. The Purchasing Card program has been in use during the entire period under investigation.

3. Expense Coding Practices of Former Senior Management

Our efforts included the evaluation of expense items incurred by former Senior Management and booked to various expense accounts in the Cooperative's general ledger. As mentioned, each individual in the possession of a Cooperative-issued purchasing card was responsible for the proper coding of such expenses to PEC's general ledger accounts. In the case of Mr. Fuelberg, we understand that the expense coding was primarily performed by one of his assistants.

Throughout the course of the period under investigation, Messrs. Fuelberg, Dahmann and Burnett routinely incurred expenses that were reimbursed through the expense voucher process. Messrs. Fuelberg and Dahmann also had credit cards issued to them through PEC's Purchasing Card program. In addition, a separate card was issued in Mr. Fuelberg's name that was used primarily for travel-related expenditures of the Board and certain other related expenses (the "travel card"). It is our understanding that Mr. Burnett was never issued a Cooperative credit card and sought

[389] Memorandum from Ron Borchers to All Chase Visa Cardholders, Re: Chase Visa Card, with May 1997 Purchasing Card Procedures attached, September 30, 1999.

reimbursement primarily through the expense voucher process or used the travel card for booking travel-related expenses.
Expense items related to Messrs. Fuelberg, Burnett and Dahmann, as well as the travel card, were routinely booked to several different general ledger accounts. Our analysis focused primarily on analyzing expenditures through these accounts, which included the following:

- Account # 820 – *Administrative & General – Office Supplies* ("GL Acct. # 820")
- Account # 835 – *Director Fees and Expenses* (GL Acct. # 835)
- Account # 955 – *Other Deductions - Envision* (GL Acct. # 955)
- Account # 502 – *Bond Issue 2002* (GL Acct. # 502)
- Account # 821 – *Contract Services* (GL Acct. # 821)

The majority of former Senior Management expenses were booked to a miscellaneous general and administrative account labeled "*Office Supplies.*" Certain other expenses incurred by former Senior Management, which appear to have been related to activities with the Board, were charged to a "*Director Fees and Expenses"* account, which is also described separately in this Report. In addition, expenses related primarily to Messrs. Fuelberg's and Burnett's travel to New Mexico on Envision-related matters appear to have been charged to an account set up for various Envision related expenditures by PEC titled "*Other Deductions – Envision*." A separate account also appears to have been established in relation to PEC's 2002 bond issue, but only limited former Senior Management expenses were charged to this account.

We also requested and reviewed the detailed credit card statements for the individuals in question, including readily available electronic statements from JP Morgan Chase Bank. Many individual transactions that were booked to the specific general ledger accounts referenced above would not include a reference identifying the cardholder that incurred the expense. In light of these data limitations, our efforts focused primarily on the identifiable expenses in the various general ledger accounts; we also undertook to reconcile those amounts to the individual credit card statements in order to ensure that the vast majority of, if not all, former Senior Management credit card expenses were included in our analysis.

4. Limitations on Work Performed

PEC has historically made widespread use of the Purchasing Card program, with approximately 70 to 80 Cooperative employees in the possession of a Cooperative-issued credit card at any time. A limited review of the various credit card transactions across the years reveals that the purchases were varied across numerous vendors, expense types, amounts and expense purposes. However, a detailed review of the Purchasing Card program and inquiry into whether all employees consistently adhered to the general guidelines established for the purchasing cards, including the distinction between authorized and unauthorized uses, is beyond the scope of this investigation. Our efforts were focused on the use of the purchasing cards by former Senior Management, and specifically Messrs. Fuelberg and Dahmann. Again, it is our understanding that Mr. Burnett was never issued a Cooperative credit card and our analysis found no evidence to the contrary.

In addition, while both PEC's expense voucher reimbursement process and the guidelines for the purchasing cards required the submission of supporting invoices and detail, in many instances that backup detail and support is missing, especially in relation to expenditures incurred by Mr. Fuelberg. Based on our discussions with certain individuals, it is our understanding that Mr. Fuelberg often failed to provide the required expense support for both his expense vouchers and applicable credit card receipts. Our ability to evaluate certain expenditures was thus limited by the availability of necessary information describing the nature of the expense.

5. Summary of Total Expenses for Former Senior Management

The Purchasing Card program has been in use by PEC throughout the period under investigation and its use is widespread. As of December 31, 2007 over 70 PEC employees were in the possession of a Cooperative issued credit card. The employees consisted primarily of former Senior Management, and Department and District managers, but others were included as well. Mr. Fuelberg and Mr. Dahmann each had a Cooperative-issued credit card. While Mr. Burnett did not have a credit card, many of his expenses along with other Board members were paid using either Mr. Fuelberg's credit card or a Cooperative "travel card" that was issued under Mr. Fuelberg's name. A summary of the expenses incurred through the various PEC credit cards is summarized in the table below:

Summary of Total Credit Card Charges for All Employees and Senior Management by Card Holder for 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
All Employees	**$251,955**	**$285,664**	**$425,590**	**$422,133**	**$572,344**	**$659,667**	**$750,153**	**$694,583**	**$812,304**	**$981,924**	**$5,856,316**
Fuelberg *	$1,200	$27,009	$59,501	$77,365	$87,348	$129,595	$80,984	$85,490	$100,258	$50,060	$698,809
Travel Card	1,367	15,925	26,509	28,338	17,215	65,318	46,844	30,837	33,218	10,331	275,901
Dahmann	2,602	5,191	11,217	8,079	38,343	30,985	29,493	13,099	19,489	13,920	172,419
Total	**$5,169**	**$48,125**	**$97,227**	**$113,781**	**$142,906**	**$225,898**	**$157,321**	**$129,426**	**$152,965**	**$74,312**	**$1,147,129**

* It should be noted that a portion of the expenses incurred on Mr. Fuelberg's card were on behalf of members of the Board and other Cooperative employees. These expenses are analyzed in a previous section of this Report.

As noted in the table above, Messrs. Fuelberg, Burnett, and Dahmann incurred over 19% of the total expenditures by PEC through the PEC corporate credit cards.

Expenses for Messrs. Fuelberg, Burnett, and Dahmann were analyzed in relation to both the expenses incurred through the expense voucher and reimbursement process, as well as expenses paid on each individual's behalf by PEC through the Cooperative-issued credit cards, including the travel card issued in Mr. Fuelberg's name. Total expenses incurred on behalf of each individual through the expense vouchers and credit cards are summarized in the following table:

Summary of Total Expenses for Senior Management for 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Bennie Fuelberg	$14,584	$25,828	$43,209	$43,148	$68,607	$105,937	$61,408	$62,156	$73,293	$44,189	$542,359	62%
W.W. Burnett	7,841	5,424	11,573	14,556	17,845	26,201	22,674	17,376	10,798	13,133	147,421	17%
Will Dahmann	5,407	7,957	12,399	10,376	24,158	48,833	30,613	14,269	20,543	14,915	189,471	22%
Total	**$27,832**	**$39,208**	**$67,181**	**$68,080**	**$110,610**	**$180,971**	**$114,695**	**$93,801**	**$104,635**	**$72,237**	**$879,251**	**100%**

While the expense voucher process has been in use at PEC for many years, its use is relatively limited in comparison to expenses incurred through credit cards and the Purchasing Card program. The preference for the purchasing cards is an understandable business policy as an alterative to requiring staff members to fund PEC-related expenses out of their own pockets subject to later reimbursement, with the additional administrative task of completing and submitting an expense reimbursement form. With regard to former Senior Management, the expense vouchers appear to have been primarily used for airfare, daily per diems, certain meal expenses and reimbursement of mileage. A summary of the expense vouchers submitted and reimbursed to Messrs. Fuelberg, Burnett, and Dahmann during the period 1998 - 2007 is provided below:

Summary of Expense Vouchers for Senior Management for 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Bennie Fuelberg	$13,671	$4,782	$10,683	$5,886	$9,197	$8,237	$7,982	$6,472	$8,554	$4,358	$79,822	37%
W.W. Burnett	7,841	5,424	11,573	11,695	11,579	16,559	18,607	15,473	8,972	10,800	118,523	55%
Will Dahmann	2,805	2,766	1,665	1,434	2,212	1,483	1,201	769	924	966	16,224	8%
Total	**$24,317**	**$12,972**	**$23,920**	**$19,015**	**$22,988**	**$26,279**	**$27,790**	**$22,714**	**$18,450**	**$16,124**	**$214,569**	**100%**

As described, Mr. Fuelberg and Mr. Dahmann each had a Cooperative-issued credit card. While Mr. Burnett did not have a credit card, many of his expenses were paid using Mr. Fuelberg's credit card or the Cooperative "travel card" that was issued under Mr. Fuelberg's name. A summary of the expenses incurred through the various PEC credit cards allocated to Messrs. Fuelberg, Burnett, and Dahmann is included in the table below:

Summary of Credit Card Expenses Allocated to Senior Management for 1998 - 2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Bennie Fuelberg	$913	$21,045	$32,526	$37,262	$59,411	$97,701	$53,426	$55,684	$64,739	$39,831	$462,537	70%
W.W. Burnett	-	-	-	2,861	6,266	9,641	4,067	1,903	1,827	2,333	28,899	4%
Will Dahmann	2,602	5,191	10,734	8,942	21,946	47,351	29,412	13,500	19,620	13,950	173,247	26%
Total	**$3,515**	**$26,236**	**$43,261**	**$49,065**	**$87,623**	**$154,692**	**$86,905**	**$71,087**	**$86,185**	**$56,113**	**$664,682**	**100%**

6. Analysis of Expenses Incurred by Messrs. Fuelberg, Burnett and Dahmann

We categorized the total expenditures incurred by each individual through the expense voucher process, the individual credit cards and the travel card (e.g., lodging, airfare, meals, etc.) by expense type for further analysis. Total expenses by expense category for Messrs. Fuelberg, Burnett and Dahmann are summarized in the table below:

Summary of Total Expenses for Senior Management for 1998 - 2007

Expense Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Lodging	$2,543	$10,716	$6,911	$12,187	$26,052	$46,079	$30,195	$31,740	$36,463	$17,291	$220,176	25%
Airfare	2,797	2,840	10,779	18,311	32,236	46,349	28,335	14,739	17,147	12,803	186,335	21%
Meals	6,520	8,136	15,483	11,104	16,932	15,807	20,730	10,469	16,496	14,481	136,157	15%
Other	715	1,710	5,931	6,071	8,126	38,904	7,943	12,008	14,078	9,589	105,075	12%
Misc/Tips	6,342	4,126	7,860	4,987	7,197	5,796	6,988	4,074	5,979	1,430	54,778	6%
Mileage	5,451	2,593	6,817	5,355	5,070	5,605	5,037	7,141	4,070	4,771	51,909	6%
Spouse Airfare	146	129	1,506	2,422	6,009	11,957	6,261	5,418	3,048	2,885	39,781	5%
Membership Fees	2,418	1,758	3,539	2,564	3,333	2,510	3,460	2,714	3,176	2,719	28,191	3%
Cell Phone	169	2,852	3,120	1,961	3,230	3,174	3,006	2,895	2,760	3,040	26,206	3%
Cab Fare/Car Rental	731	2,989	4,057	2,236	1,339	3,557	2,740	2,604	1,418	3,229	24,900	3%
Registration Fees	-	1,360	1,180	884	50	-	-	-	-	-	3,474	0%
Unclassified	-	-	-	-	1,036	1,235	-	-	-	-	2,271	0%
Total	**$27,832**	**$39,208**	**$67,181**	**$68,080**	**$110,610**	**$180,971**	**$114,695**	**$93,801**	**$104,635**	**$72,237**	**$879,251**	**100%**

Each expense category, as well as numerous individual expenses, were further analyzed for Messrs. Fuelberg, Burnett, and Dahmann in relation to the identified purpose and nature of the expenses, including whether the expenses were supported by underlying invoices or receipts, and whether the expense could be related to a specific Cooperative or Senior Management meeting, conference, or other designated Cooperative purpose.

7. Analysis of Expenses Incurred by Mr. Fuelberg

As described, Mr. Fuelberg accounted for the majority of expenses (62%) for former Senior Management during the period 1998 – 2007, including nearly 70% of the credit card charges. A breakdown of Mr. Fuelberg's expenses by category is summarized in the table below:

Summary of Total Expenses for Bennie Fuelberg for 1998 - 2007

Expense Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Lodging	$1,915	$8,995	$3,869	$8,016	$17,794	$30,197	$14,218	$19,419	$20,068	$9,389	$133,879	25%
Airfare	2,797	1,981	7,145	11,188	18,784	30,090	16,482	11,880	13,345	8,883	122,573	23%
Meals	1,430	3,131	9,561	7,433	10,723	8,388	6,346	5,742	12,971	8,631	74,356	14%
Other	28	899	3,808	4,530	4,184	14,143	6,281	10,290	12,933	5,771	62,866	12%
Misc/Tips	5,353	2,957	5,665	2,889	5,497	4,239	3,794	2,785	4,521	1,198	38,899	7%
Spouse Airfare	146	129	1,506	1,914	4,454	9,312	5,892	4,510	2,516	1,758	32,136	6%
Membership Fees	2,418	1,758	3,539	2,564	3,333	2,510	3,460	2,714	3,176	2,719	28,191	5%
Cell Phone	169	2,852	3,120	1,961	3,230	3,174	3,006	2,895	2,760	3,040	26,206	5%
Cab Fare/Car Rental	156	1,745	3,368	1,771	559	2,650	1,929	1,922	1,003	2,801	17,905	3%
Registration Fees	-	1,360	1,180	884	50	-	-	-	-	-	3,474	1%
Unclassified	-	-	-	-	-	1,235	-	-	-	-	1,235	0%
Mileage	171	20	449	-	-	-	-	-	-	-	640	0%
Total	**$14,584**	**$25,828**	**$43,209**	**$43,148**	**$68,607**	**$105,937**	**$61,408**	**$62,156**	**$73,293**	**$44,189**	**$542,359**	**100%**

The majority of expenses incurred by Mr. Fuelberg through the expense voucher process and his Cooperative credit card were travel-related (i.e., lodging, airfare, spouse airfare, cab fare/car rental), though "meals" and "other" expenses account for significant portions of the total. As illustrated above, Mr. Fuelberg frequently incurred expenses paid for by the Cooperative across a wide-range of expense types. On average, Mr. Fuelberg incurred business-related expenses through his expense voucher or credit card on over 130 days out of each year. The various categories of expenditures are further discussed in detail below.

Lodging/Airfare/Spouse Airfare Expenses

The majority of costs incurred by Mr. Fuelberg through his corporate credit card and expense vouchers were in relation to various travel expenses, primarily lodging and airfare, including airfare costs for spousal travel. During the period 1998 - 2007, 25% of Mr. Fuelberg's total expenses were related to lodging, 23% to airfare, and 6% to airfare for Mr. Fuelberg's spouse.

Mr. Fuelberg routinely traveled on behalf of the Cooperative and was said to have frequently traveled to the various District offices. Over the years, Mr. Fuelberg attended numerous conferences and meetings hosted by various groups including the National Rural Electric Cooperatives Association ("NRECA"), Texas Electric Cooperatives ("TEC"), the American Public Power Association ("APPA"), and the Cooperative Finance Corporation ("CFC"), as well as various meetings with investment bankers and rating agencies (e.g., Fitch) in connection with the Cooperative's bond offerings and rating agency assessments on those bonds. These conferences and meetings were held at various destinations around the country.

In addition, in his capacity as a Board member and the executive essentially in control of the Envision subsidiary, Mr. Fuelberg made numerous trips to New Mexico for Board meetings and other Envision related purposes. Mr. Fuelberg also hosted various Directors' workshops, primarily in San Antonio, as well as certain manager retreats. A summary of the various trips to select destinations taken by Mr. Fuelberg during the period 1998 – 2007 is summarized in the table below:

Summary of Lodging and Airfare for Bennie Fuelberg by Destination for 1998 - 2007

Destination	Trips	Lodging	Airfare	Total
New Mexico/Arizona	82	$ 27,326	$ 48,852	$ 76,177
Washington D.C.	16	13,924	35,187	49,111
San Antonio		24,209	-	24,209
New York	6	13,961	8,738	22,699
Boston (New England)	4	6,892	12,074	18,966
Austin/Horseshoe Bay		16,941	-	16,941
Seattle	5	5,727	7,904	13,630
Florida	6	3,171	9,326	12,497
San Francisco	3	3,801	7,391	11,192
Las Vegas	7	3,491	3,051	6,542
Phoenix	5	2,347	3,474	5,821
Minnesota	2	1,079	4,357	5,436
Wyoming	2	1,526	3,834	5,360
Columbus (Ohio)	1	181	1,837	2,018
Nashville	2	407	1,411	1,818
Other		8,897	7,273	16,170
Total		**$ 133,879**	**$ 154,709**	**$ 288,588**

As indicated in the table above, a significant portion of Mr. Fuelberg's expenses were incurred during trips to New Mexico in connection with Envision Board meetings as described. Other notable destinations included Washington, D.C. (headquarters for both the NRECA and APPA) and San Antonio, where, as described above, the Cooperative routinely held various Director workshops and managers' retreats.

For purposes of our analysis, we evaluated the dates and, if available, the indicated purpose for the lodging and airfare expenses in relation to the various trips taken by Mr. Fuelberg. However, as noted, many of the expense vouchers and supporting credit card statements submitted by Mr. Fuelberg over the years lack the required support documentation describing the nature and purpose of each expense. Where information was available, we attempted to correlate the various travel expenses incurred by Mr. Fuelberg to identifiable business purposes. We also had access to the calendar (i.e., "GM Calendar") used by PEC management for planning purposes during many of the years in question. The calendar would typically include Mr. Fuelberg's schedule, as well as Mr. Dahmann's, including Board related meetings and events.

In summary, we have been able to classify almost 83% of the lodging and airfare expenses to one of the various meetings and conferences attended by Mr. Fuelberg. The remaining lodging expenses and airfare were unable to be classified, primarily due to missing support documentation (i.e., invoices and receipts) or lack of the historical GM Calendar for reference in those periods. A breakdown of the identified conference/meeting sponsor or purpose for the lodging and airfare (including spouse) expenses is summarized below:

Summary of Lodging and Airfare Expenses by Identified Business Purpose for 1998 - 2007

Business Purpose	Lodging Expenses	Airfare Expenses	Airfare & Lodging	% of Total
Envision Meetings	$ 20,803	$ 34,934	$ 55,738	19.31%
NRECA Conferences	13,795	20,485	34,280	11.88%
Bond/Rating Agencies	13,058	19,948	33,006	11.44%
ALDC Conferences	8,288	10,234	18,522	6.42%
Austin/Horseshoe Bay	16,941	-	16,941	5.87%
APPA Conferences	9,606	7,264	16,870	5.85%
Directors' Workshops	15,730	-	15,730	5.45%
CFC Conferences	4,948	3,956	8,903	3.09%
Managers' Retreats	3,369	-	3,369	1.17%
TEC Meetings	2,009	1,267	3,275	1.13%
Other	10,265	22,226	32,490	11.26%
Unclassified	15,068	34,396	49,465	17.14%
Total	**$ 133,879**	**$ 154,709**	**$ 288,588**	**100.00%**

As indicated in the table above, a significant portion of Mr. Fuelberg's expenses were incurred in relation to the Envision Board meetings, which is consistent with the destination of New Mexico and Arizona for the vast majority of his trips as indicated in the prior table. Significant expenses were also incurred in relation to Mr. Fuelberg's participation in various meetings and conferences held each year by the NRECA, the APPA, and other industry organizations, which generally correlate to numerous trips taken by Mr. Fuelberg to Washington, D.C. over the last 10 years.

In addition, various expenses classified as "lodging," due to their relationship to various hotels and resorts in and around Austin, appear to be more related to expenses for meeting rooms and banquet facilities. These expenses were categorized separately as "Austin/Horseshoe Bay," with Horseshoe Bay being the location at which the Cooperative routinely has held its various awards luncheons and other functions. While not all expenses have been classified, we did not identify any significant expenditure that appeared unrelated to the documented business purpose, and none that appeared solely personal in nature.

A majority of the travel-related expenses appear to be in conjunction with various conferences, meetings and workshops attended by Mr. Fuelberg throughout the year. Of initial concern, expenses to so-called "leisure destinations" such as Las Vegas, Florida, Boston, Seattle and Jackson Hole, Wyoming, among others, were evaluated more closely as Mr. Fuelberg's spouse also accompanied him to many of these destinations. However, based on the process described above, most of these trips also appear to have been in relation to the various conferences and meetings as described.

As examples, listings of the travel-related expenses for trips by Mr. Fuelberg to Las Vegas and San Francisco, with the corresponding identified business purposes, are further detailed below:[390]

Summary of Expenses for Mr. Fuelberg for Travel to Las Vegas from 1998 - 2007

Date	Lodging / Airfare	Other	Total Expenses	Business Purpose
February-98	$ 233	$ 311	$ 544	NRECA Director's Conference
February-99	676	192	868	NRECA Director's Conference
February-00	548	222	770	NRECA Conference (2/11-2/16)
November-02	692	98	790	NRECA Conference (11/13-11/15)
March-05	1,085	238	1,323	NRECA Director's Conf. (3/20-3/22)
April-05	946	-	946	NRTC Tech Conference (4/25-4/27)
March-07	2,362	781	3,143	NRECA Conference (3/18-3/20)
Total	**$ 6,541**	**$ 1,842**	**$ 8,384**	

Summary of Expenses for Mr. Fuelberg for Travel to San Francisco from 1998 - 2007

Date	Lodging / Airfare	Other	Total Expenses	Business Purpose
September-02	$ 6,281	$ 1,783	$ 8,065	Bond Issue - Standard & Poors
August-04	3,035	187	3,222	Meeting w/ Standard & Poors
April-05	1,876	1,068	2,944	Meeting w/ Standard & Poors
Total	**$ 11,192**	**$ 3,039**	**$ 14,231**	

[390] Expenses include all expenses associated with the travel to each destination included meals and other miscellaneous items (e.g., tips, taxi, etc.).

While $239,123 or 83% of the total travel-related expenses (i.e., lodging, airfare and spouse airfare) have been correlated with what appears to be valid business purposes, insufficient information exists to make a determination with regard to the remaining $49,465 in identified travel-related expenditures.

Although most of the travel-related expenses appear to have been in relation to valid business purposes, many of the expenses incurred by Mr. Fuelberg were at higher-end hotels and involved first-class airfare travel for himself and his spouse, when he was so accompanied. While there were no express provisions in either the Cooperative's polices or Board resolutions prohibiting Mr. Fuelberg from traveling first-class, from being accompanied by his spouse, or from staying at higher-end hotels, we evaluated the relative costs to the Cooperative and its members for these items in more detail.

The total identified airfare incurred by Mr. Fuelberg during the period under investigation was approximately $154,709, which was over 28% of the total cost of his expenses to the Cooperative. Of that amount, approximately $32,136 or 21% of it was in relation to spouse airfare for trips on which he was accompanied by his spouse. Of the expenses reviewed, Mr. Fuelberg flew over 120 times during the period 1998 - 2007 with his spouse apparently accompanying him approximately 25% of the time.

Approximately 40% of the flights taken by Mr. Fuelberg were through regional budget carriers such as Southwest Airlines. The remaining 60% were taken through domestic/international carriers (e.g., American, Continental, etc.) and were typically booked as business or first-class fares. Mrs. Fuelberg, when she accompanied him, was booked on the same fares. Excluding the flights on Southwest Airlines, Mr. Fuelberg's average cost per roundtrip flight was approximately $1,400. In some instances, we determined that even short-haul flights between Austin and Dallas were booked in business or first-class, with significant premiums above the low-cost alternatives. As an example, a first-class flight by Mr. Fuelberg on American Airlines between Austin and Dallas in December 2000 cost the Cooperative approximately $945.

A list of airfare expenses incurred by Mr. Fuelberg during the period 1998 - 2007 is provided in Exhibit 29**.**

Based on our analysis and assumptions as to the relative difference between coach and business or first-class fares, the additional costs to PEC for Mr. Fuelberg's airfare, including airfare for his spouse, were approximately $65,000 - $75,000 over the ten-year period between 1998 and 2007.

In addition to business and first-class airfare, Mr. Fuelberg also routinely stayed at higher-end hotels at his travel destinations, including hotels such as The Four Seasons (at various destinations), the Fairmont in Seattle and San Francisco, and the Essex House in New York. While some of the hotels in question were the site of various conferences, it is our understanding that Mr. Fuelberg routinely selected the hotels, many of which were more expensive accommodations than the conference-sponsored hotels. A summary of the number of stays at various higher-end hotels and their assorted locations is provided in the following table:

Summary of Stays at Select Hotels by Bennie Fuelberg from 1998 - 2007

Hotel	# of Stays	Locations/Description
El Dorado Hotel	13	Santa Fe
The Four Seasons	12	New York, Boston, San Francisco, Seattle, Chicago, Las Vegas, Teton Village, Irving (TX)
The Jefferson Hotel	12	Washinton D.C.
La Fonda Hotel	7	Santa Fe
The Fairmont	4	Seattle, San Francisco
Other Las Vegas Hotels	4	The Mirage, The Venetian, The Wynn, The Bellagio
Inn and Spa at Loretto	3	Santa Fe
The Ritz Carlton	2	New York
Disney Resort	1	Lake Buena Vista, FL
Essex House Hotel	1	New York
Total Stays	**59**	

A list of lodging expenses incurred by Mr. Fuelberg from 1998 – 2007 is provided in Exhibit 29**.**

A sample of Mr. Fuelberg's lodging expenses during the 2006 through 2007 timeframe was analyzed in greater detail. Mr. Fuelberg's average accommodations during this period were at a rate of approximately $400 per night (including taxes and other charges) and approximately $245 per night (excluding these charges). However, it is well-known that lodging rates vary considerably depending on the city in question. While a $250-per-night hotel room may be considered lavish in certain cities, it would be considered a budget accommodation in others (e.g., New York).

PEC's new *Travel Expense Reimbursement Policy* establishes a baseline of $250 per night (before taxes) for lodging.[391] In comparison to the newly adopted travel policy, a majority of the lodging expenses incurred by Mr. Fuelberg in 2006 and 2007 appear to have been at a standard rate of less than $250 per night (before taxes). However, a number of the lodging expenses also appear to have been significantly in excess of the $250 per night guideline including the following:

[391] Travel Expense Reimbursement Policy, Pedernales Electric Cooperative, Inc., Board adopted March 17, 2008.

Summary of Select Lodging Expenses for Bennie Fuelberg for 1998 - 2007						
Date	**Hotel**	**Location**	**Business Purpose**	**Nights**	**Amount**	**Lodging Per Night**
4/22/1999	Essex House Hotel	New York, NY	GM Calendar Unavailable	2	$1,704	$852
4/26/2000	El Dorado Hotel	Santa Fe	Envision Board Meeting	2	544	272
2/23/2001	The Jefferson Hotel	Washington DC	Meeting w/ NRECA, LCRA, CFC, AEP	1	497	497
5/8/2002	The Jefferson Hotel	Washington DC	NRECA Legislative Conference	2	1,490	745
4/6/2003	Westin Hotels Riverwalk	San Antonio	Directors' Workshop	2	730	365
6/24/2004	Fairmont Olympic Hotel	Seattle	APPA Conference	3	1,857	619
2/9/2005	The Jefferson	Washington DC	APPA Legislative Rally	3	2,368	789
3/10/2005	Four Seasons Hotels	Irving, TX	WildBlue Operations Meeting	1	840	840
4/29/2005	The Fairmont Hotel	San Francisco, CA	Meeting with Standard & Poors	2	894	447
5/3/2005	The Jefferson	Washington DC	NRECA Legislative Conference	2	1,086	543
5/6/2005	Four Seasons Hotels	Boston	Guiding Your Retirement Program	3	2,430	810
10/13/2005	Four Seasons Hotels	New York City	Meeting with Fitch Ratings	3	4,670	1,557
6/8/2006	The Ritz Carlton	Naples, FL	Mtg. at Lee County Electric Coop.	2	1,195	597
11/9/2006	The Ritz Carlton	New York City	Meeting with Fitch Ratings	1	1,604	1,604
3/20/2007	Wynn Las Vegas Hotel	Las Vegas	NRECA Conference	2	1,159	580
Total				**31**	**$23,067**	**$744**

The reasonableness of hotel accommodations is a subjective question, given that rates for "reasonable accommodations" can vary widely by destination, time of year, and type of accommodation, as well as determined by overall market forces including hotel occupancy rates, negotiated discounts, and time of booking. Given these factors, while "lavish or extravagant" expenses are typically not deductible for federal income tax purposes, even the IRS acknowledges that "expenses will not be disallowed just because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs or resorts."[392]

An evaluation of individual lodging expenses for reasonableness with any degree of reliability is beyond the scope of this investigation, as reasonableness would depend in large part on many of the factors just described. In some instances, the lodging choice was pre-determined by the meeting or conference site, while in others Mr. Fuelberg appears to have selected different lodging, including more prestigious and expensive lodging, from that of the general meeting or conference participants.

In hindsight, there is no question that Mr. Fuelberg chose accommodations at hotels well-known to be at the upper-end in terms of cost and prestige. There is also no question that alternate "reasonable accommodations" existed for many of these hotels, and that many of Mr. Fuelberg's hotel choices would not have been consistent with PEC's current policy. On average, Mr. Fuelberg's average per night lodging expenses appear to have been approximately 35% higher than levels consistent with the existing $250-per-night baseline established by PEC's new policy.

Prior to the adoption of PEC's new *Travel Expense Reimbursement Policy* in early 2008, PEC did not have a per-diem rate guideline for airfare or lodging that applied to Mr. Fuelberg, the managers or the Directors. PEC's expense reimbursement policy merely stated that "reasonable accommodations" would be made for employees traveling on Cooperative business.

[392] 2007 Internal Revenue Service, Publication 463 - Travel, Entertainment, Gift, and Car Expenses.

However, if the Board had previously implemented and enforced a more specific and restrictive travel expense reimbursement policy with similar guidelines to that of the current policy, Mr. Fuelberg's total lodging expenses during the relevant period would likely have been significantly lower. Based on an estimated average 35% premium paid by Mr. Fuelberg for these hotels, a more restrictive policy would have resulted in approximately $20,000 - $25,000 in savings to the Cooperative.

While many of the lodging and airfare expenses appear to have been in connection with identified business purposes, on a number of occasions, and primarily in connection with trips on which Mr. Fuelberg was accompanied by his wife, it appears that Mr. Fuelberg extended his trip to include additional personal or leisure travel and activities. Although limited information is available surrounding some of these trips, on several occasions Mr. Fuelberg and his wife appear to have arrived either a day or two early or stayed an additional day or two after the business-related event at the apparent expense of the Cooperative. One noteworthy example was a trip to New Hampshire and Boston in 2003, which is further described below.

The purpose of the trip was for a meeting of the Association of Large Distribution Cooperatives ("ALDC"), a group of approximately 12 larger distribution cooperatives that had formed an association focused on the specific needs of larger cooperatives (the average member cooperative in the NRECA was significantly smaller). The meeting was held at the Grand Summit Hotel & Conference Center in Bartlett, New Hampshire on Thursday and Friday October 9 - 10, 2003 (*specifically through 11:00 a.m. on the 10th*). However, Mr. Fuelberg and his spouse arrived on October 3rd and departed on October 12th.

At the beginning of the trip, Mr. Fuelberg and his spouse spent two nights in Boston at the Four Seasons Hotel and two nights in Woodstock, Vermont at the Woodstock Inn. In addition, Mr. Fuelberg and his spouse spent an additional night at the Grand Summit Hotel and one night at another smaller motel in New Hampshire. Several meals were also expensed during the period before and after the meeting. In addition, Mr. Fuelberg was reimbursed for a per diem each day during the trip ranging from $45 - $70 dollars each day, $646 in total (October 3 – October 12). A summary of the expenses incurred by Mr. Fuelberg and paid through his credit card and the expense vouchers he submitted for this trip are summarized as follows:

Summary of Expenses for Bennie Fuelberg Related to 2003 ALDC Meeting in Bartlett, NH				
Departure / Check-in	Return / Check-out	Vendor	Amount	Destination / Location
10/3/2003	10/12/2003	American Airlines (Fuelberg)	$ 2,154.00	Boston (round-trip)
10/3/2003	10/12/2003	American Airlines (Spouse)	2,154.00	Boston (round-trip)
Total Airfare			**$ 4,308.00**	
10/3/2003	10/5/2003	Four Seasons Hotels	$ 1,661.38	Boston
10/5/2003	10/8/2003	Woodstock Inn	2,320.66	Woodstock, VT
10/8/2003	10/10/2003	Grand Summit Hotel	407.41	Bartlett, NH
10/11/2003	10/12/2003	Intervale Motel	31.45	No Conway, NH
Total Lodging			**$ 4,420.90**	
Meals			**825.45**	
Per Diems			**645.97**	
Total Expenses			**$ 10,200.32**	

The total cost of the trip, all of which appears to have been paid by the Cooperative, is estimated to have been at least $10,200. However, the overall cost to the Cooperative for the entire ALDC meeting was substantially higher. In addition to Mr. Fuelberg and his wife, all of the PEC Directors were invited to the meeting, including their spouses, as well as PEC's outside Counsel Walter Demond (Clark Thomas) and David Sibley, a long-time lobbyist for the Cooperative. Mr. Sibley was also invited to accompany Mr. Fuelberg and his wife during the first few days of the trip to Vermont. The total cost to the Cooperative for essentially a nine hour meeting in New Hampshire appears to have been over $58,000.

Several other examples have been noted including various trips to New Mexico for Envision related Board and other meetings. Many of the trips included car rental for travel from El Paso to Ruidoso, New Mexico (where Mr. Fuelberg has had a second residence since 1998), as well as meals in Ruidoso. While many of the Envision meetings appear to have been one-day meetings of the Board, on various occasions, Mr. Fuelberg's travel included several day stays, often with meals and daily per diems charged to the Cooperative for those days.

On most of the "leisure-added" trips, Mr. Fuelberg was apparently accompanied by his wife. She appears to have accompanied him on over 30 trips during the ten-year period under investigation, with the majority of these trips being to New Mexico. While not all of these trips exhibit the same characteristics as the two examples highlighted above, many others appear to involve an extra day or two on the trip and include questionable per diems and meals. However, as indicated above, information is limited with regard to whether Mr. Fuelberg conducted other business during these trips or whether the extra time was primarily personal in nature. A list of travel related expenses on trips where Mr. Fuelberg was accompanied by his wife is attached as Exhibit 30.

Meal and Entertainment Expenses

PEC's travel and expense reimbursement policy applicable during the investigation period did not have a per-diem rate for meals or other expenditures. Most management reimbursements appear to have been for the actual expenses incurred, or the expenses were paid directly by PEC. PEC's expense policy for this period cites only that meal expenses are subject to the same "business connection" requirement as applied to entertainment expenses.

Mr. Fuelberg used his credit card frequently for meals. However, as previously discussed, he reportedly traveled to various conferences, meeting and workshops, and made frequent visits to the individual PEC districts. A majority of the meal expenses incurred by Mr. Fuelberg, almost 70%, were less than $100 per transaction. A small number of large group meals booked to his credit card make up the largest portion of the meal expenditures attributable to him. The breakdown of meal expenses charged by Mr. Fuelberg is summarized below:

Summary of Meals for Bennie Fuelberg by Price Range (1998 - 2007)

Price Range	# of Meals	%	Amount	%
$0 - $50	206	39.39%	$ 6,747	9.07%
$50 - $100	159	30.40%	11,362	15.28%
$100 - $500	135	25.81%	25,234	33.94%
$500 - $750	8	1.53%	4,972	6.69%
Over $750	15	2.87%	26,041	35.02%
Total	**523**	**100.00%**	**$ 74,356**	**100.00%**

Based on our analysis, we identified approximately 17 such apparent group meals (>$750) at various well-known high-end restaurants such as Morton's of Chicago and The Palm Restaurant.

Summary of Meals for Bennine Fuelberg Greater than $750 for 1998 - 2007

Date	Amount		Restaurant	Location	Business Purpose
5/10/1999	$ 971.16		Little Rhein Steak House	San Antonio	Unclassified
2/23/2000	1,909.07		Rio Rio Cantina	San Antonio	Managers' Retreat
9/13/2000	2,831.34		Morton's of Chicago	San Antonio	Managers' Retreat
1/16/2001	2,065.62		Morton's of Chicago	San Antonio	Managers' Retreat
5/24/2001	802.26		Little Rhein Steak House	San Antonio	Large Electric Co-op Meeting
6/20/2001	1,281.75		Pecan Street Café	Austin	Unclassified
12/12/2001	3,107.12		Palm Restaurant	San Antonio	Managers' Retreat
8/1/2002	1,521.34		Boudro's	San Antonio	Deregulation Dinner Meeting w/ LCRA
8/5/2002	1,971.28	*	Palm Restaurant	Dallas	TEC Annual Meeting
9/18/2002	1,059.03		Water Street Seafood	Corpus Christi	Managers' Retreat
8/12/2003	2,090.39		Morton's of Chicago	San Antonio	Managers' Retreat
1/22/2004	3,098.27	*	Morton's of Chicago	San Antonio	Board Retreat
9/8/2005	813.18		Pappadeaux Seafood Kitchen	San Antonio	Will Martin Retirement Lunch
1/17/2006	1,679.74		Palm Restaurant	San Antonio	Managers' Retreat
2/19/2006	2,360.87		Palm Restaurant	Orlando, FL	NRECA Annual Meeting
4/12/2006	885.95		Pappadeaux Seafood Kitchen	San Antonio	Benny Jarvis Retirement Lunch
6/26/2006	2,662.36		Morton's of Chicago	San Antonio	Managers' Retreat
Total	**$ 31,110.73**				

* These expenses were originally miscoded in the credit card statements.

In total, these 17 meals account for over 35% of Mr. Fuelberg's meal related expenses. Many, if not most, of these meal expenses appear to have been incurred in connection with various managers' retreats in San Antonio and conferences attended by Directors, with apparent benefit to the managers and Directors.

Other/Miscellaneous Expenses

Various other/miscellaneous expenditures were made by Mr. Fuelberg through his Cooperative credit card over the years. A summary of certain of these expenses is provided below:

Summary of Other Expenses for Bennie Fuelberg for 1998 - 2007

Date	Vendor	Amount	Business Purpose
1/19/2000	Pottery Barn	$ 1,832	Unknown
9/19/2001	Furniture Concepts	3,138	Sofa and Chairs
11/11/2002	Cabela's Inc	431	Bobwhite & Quail Mounts (3)
12/16/2002	HEB	1,084	Unknown
4/23/2003	Lake Austin Spa Resort	1,008	Four Half-days at Spa
9/9/2004	Woody's Sports Center	200	Unknown
9/23/2004	Ruidoso Hawthorn Suite Golf	189	Envision Board Mtg. - 9/23/2004
2/5/2005	Apple Store	2,746	New Computer
3/18/2005	Ruidoso Hawthorn Suite Golf	140	Envision Board Mtg. - 3/17/2005
1/12/2006	Best Buy	519	Unknown
2/9/2006	Horseshoe Bay Marina	4,484	Unknown
3/17/2006	Caprock Pro Shop	1,029	Golf at Horseshoe Bay
9/5/2006	Apple Store	2,099	New Computer
11/16/2006	Casino Knights	255	Holiday Party Entertainment
12/9/2006	Apple Store	433	Microsoft Office 2004
12/12/2006	Casino Knights	255	Holiday Party Entertainment
3/28/2007	CompUSA	1,676	New Computer
6/1/2007	Bag 'N Baggage	577	Unknown
9/14/2007	Apple Store	108	Unknown
10/8/2007	Best Buy	181	Unknown
Total		**$ 22,384**	

Additionally, Mr. Fuelberg used his credit card to make purchases of chocolates and candies from Godiva Chocolates and Texas Hill Country Pecans. A summary of expenses is provided below:

Summary of Chocolate and Candy Expenses for Bennie Fuelberg for 1998 - 2007					
Date	**Vendor**	**Amount**	**Date**	**Vendor**	**Amount**
5/23/2003	Godiva Chocolates	$ 52	4/30/2003	Texas Hill Country Pecans	$ 3,195
7/28/2003	Godiva Chocolates	171	5/28/2003	Texas Hill Country Pecans	2,296
8/11/2003	Godiva Chocolates	62	10/7/2003	Texas Hill Country Pecans	1,540
12/6/2003	Godiva Chocolates	377	**Total**		**$ 7,031**
2/7/2004	Godiva Chocolates	43			
5/1/2004	Godiva Chocolates	64			
9/21/2004	Godiva Chocolates	321			
11/11/2004	Godiva Chocolates	35			
12/12/2004	Godiva Chocolates	70			
12/21/2004	Godiva Chocolates	102			
2/12/2005	Godiva Chocolates	551			
8/6/2005	Godiva Chocolates	92			
11/1/2005	Godiva Chocolates	92			
12/6/2005	Godiva Chocolates	361			
11/22/2006	Godiva Chocolates	422			
2/9/2007	Godiva Chocolates	682			
4/14/2007	Godiva Chocolates	81			
5/5/2007	Godiva Chocolates	76			
Total		**$ 3,653**			
Grand Total					**$ 10,684**

8. Analysis of Expenses Incurred by Mr. Burnett

As previously referenced, Mr. Burnett did not have a Cooperative-issued credit card. Mr. Burnett's expenses were primarily reimbursed through the expense voucher process, with travel and lodging expenses typically paid by the Cooperative through the Cooperative travel card. A summary of the total identified expenses for Mr. Burnett by category is provided in the table below:

Summary of Total Expenses for W.W. Burnett for 1998 - 2007*												
Expense Type	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**	**% of Total**
Mileage	$5,279	$2,573	$6,369	$5,355	$ 5,070	$ 5,605	$ 5,037	$7,141	$4,070	$4,771	$51,269	35%
Lodging	628	720	1,654	2,116	3,322	7,872	8,453	6,095	2,996	5,448	39,303	27%
Airfare	-	-	-	2,353	4,550	6,816	4,670	995	1,295	1,207	21,886	15%
Misc/Tips	989	1,169	2,195	2,098	1,700	1,556	3,194	1,289	1,458	232	15,879	11%
Meals	821	578	1,271	1,986	1,123	1,155	838	861	363	294	9,289	6%
Spouse Airfare	-	-	-	508	1,556	2,645	361	908	532	1,127	7,637	5%
Cab Fare/Car Rental	124	385	85	141	225	552	120	88	85	55	1,859	1%
Other	-	-	-	-	299	-	-	-	-	-	299	0%
Total	**$7,841**	**$5,424**	**$11,573**	**$14,556**	**$17,845**	**$26,201**	**$22,674**	**$17,376**	**$10,798**	**$13,133**	**$147,421**	**100%**

* Of the total $147,421 in expenses incurred, $7,168 of airfare and spouse airfare was allocated to GL Account 835 - Director Fees and Expenses.

Lodging/Airfare/Spouse Airfare Expenses

The majority of expenses incurred by Mr. Burnett were also travel-related. As with Mr. Fuelberg, Mr. Burnett was an officer of the Envision subsidiary and he routinely traveled to New Mexico for Envision Board or other related meetings. Expenses related to Mr. Burnett's travel to and from New Mexico (as well as sometimes Arizona) for Envision-related meetings accounted for approximately $68,578 or 47% of his total expenditures. Mr. Burnett also had his spouse accompany him on various trips at the Cooperative's cost. In total, it appears that Mr. Burnett's spouse accompanied him on nine trips over the past ten years. The majority of other lodging and airfare related expenses incurred by Mr. Burnett appear in relation to the various NRECA, APPA, CFC and ALDC meetings and conferences identified.

Mileage Expenses

The largest component of expenses incurred by Mr. Burnett (approximately $51,269) was mileage related. The vast majority of this amount was mileage in relation to Envision. Mr. Burnett apparently drove to New Mexico for many of the Envision-related meetings, thereby incurring mileage related expenses for the approximate 1,400 mile round trip from Johnson City to Santa Fe. It is our understanding that Mr. Burnett had a large ranch in New Mexico and presumably was driving to have a vehicle available to him for other purposes in relation to his ranch. The average $400 - $500 mileage expenses for these trips were likely not significantly more or less expensive than airfare would have been.

However, on a number of occasions it was noted that Mr. Burnett charged round-trip mileage from New Mexico to Johnson City to attend a PEC Board meeting, as well as other functions in Austin and elsewhere. While mileage is generally a reimbursable expense, it is questionable as to why Mr. Burnett would expense round-trip mileage from New Mexico to Texas when the typical cost to the Cooperative for him traveling to a PEC Board meeting was generally less than $30 for a 70 mile round-trip. A summary of the mileage reimbursed for Mr. Burnett for both one-way and round-trips from New Mexico to Texas are summarized below:

Summary of Mileage Expenses from New Mexico to Texas (round-trip) for W.W. Burnett for 1998 - 2007

Actual Mileage Expenses Incurred							Standard Mileage From Wimberley			
Date	From	To	Business Purpose	Mileage	Mileage Rate	Amount	Avg. Mileage	Mileage Rate	Reimb. Amount	Difference
8/9/2005	Santa Fe, NM	Austin	LCRA GAB Meeting	1,533	0.405	$ 621	120	0.405	$ 49	$ 572
9/19/2005	Santa Fe, NM	Johnson City	PEC Board Meeting	1,533	0.405	621	70	0.405	28	592
10/11/2005	Santa Fe, NM	Austin	LCRA GAB Meeting	1,533	0.405	621	120	0.405	49	572
11/21/2005	Santa Fe, NM	Johnson City	PEC Board Meeting	1,533	0.405	621	70	0.405	28	592
6/7/2005	Santa Fe, NM	Austin	LCRA GAB Meeting	1,500	0.405	608	120	0.405	49	559
6/18/2005	Santa Fe, NM	Johnson City	PEC Board Meeting	1,500	0.405	608	70	0.405	28	579
5/4/2001	Santa Fe, NM	Abilene	AEP Golf	1,520	0.345	524	500	0.345	173	352
8/10/2004	Santa Fe, NM	Austin	LCRA GAB Meeting	1,200	0.375	450	120	0.375	45	405
8/4/2002	Santa Fe, NM	Dallas	TEC Annual Meeting	1,200	0.365	438	500	0.365	183	256
6/8/1998	Santa Fe, NM	Wimberley	New Home	774	0.315	244	-	0.315	-	244
9/11/2003	Santa Fe, NM	San Antonio	Directors' Meeting	650	0.365	237	130	0.365	47	190
7/15/2002	Santa Fe, NM	Johnson City	PEC Board Meeting	622	0.365	227	70	0.365	26	201
7/16/2002	Santa Fe, NM	Johnson City	PEC Board Meeting	622	0.365	227	70	0.365	26	201
9/16/2002	Santa Fe, NM	Johnson City	PEC Board Meeting	622	0.365	227	70	0.365	26	201
10/18/2002	Santa Fe, NM	Johnson City	PEC Board Meeting	622	0.365	227	70	0.365	26	201
					Total	**$ 6,500**		**Total**	**$ 781**	**$ 5,719**

While it also appears that Mr. Burnett charged less mileage in relation to certain trips to New Mexico (presumably when he was already at his ranch in New Mexico) it is concerning that in many respects the Cooperative paid for Mr. Burnett's routine travel to his ranch in New Mexico, trips Mr. Burnett would likely have taken anyway.

Meal and Entertainment Expenses

In comparison to Mr. Fuelberg, Mr. Burnett's meal related expenses were relatively low during the past ten years. In addition, the vast majority of his meal related expenditures were under $100. We noted no significant group meals in excess of $500 incurred and reimbursed to Mr. Burnett.

Summary of Meals for W.W. Burnett by Price Range (1998 - 2007)

Price Range	# of Meals	%	Amount	%
$0 - $50	200	79.68%	$ 5,353	57.63%
$50 - $100	46	18.33%	2,990	32.19%
$100 - $500	5	1.99%	946	10.18%
$500 - $750	0	0.00%	-	0.00%
Over $750	0	0.00%	-	0.00%
Total	**251**	**100.00%**	**$ 9,289**	**100.00%**

Other/Miscellaneous Expenses

The only other significant expense of note for Mr. Burnett was for a number of apparent golf outings, including a general club membership at Horseshoe Bay. The monthly club dues and the various expenditures that appear golf related totaled in excess of $12,000. The detail of the golf related expenses are provided in Exhibit 31.

9. Analysis of Expenses Incurred by Mr. Dahmann

The expenses incurred by Mr. Dahmann were also evaluated. As with Mr. Fuelberg, Mr. Dahmann incurred expenses primarily through the use of a Cooperative-issued credit card. A summary of the total expenses incurred by Mr. Dahmann through his Cooperative-issued credit card, as well as through the expense voucher reimbursement process, is provide in the table below:

Summary of Total Expenses for Will Dahmann for 1998 - 2007

Expense Type	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total	% of Total
Meals	$4,269	$4,428	$4,651	$1,685	$5,086	$6,263	$13,546	$3,866	$3,163	$5,555	$52,511	28%
Lodging	-	1,000	1,388	2,056	4,936	8,010	7,524	6,226	13,398	2,455	46,993	25%
Other	687	811	2,123	1,541	3,643	24,762	1,662	1,718	1,146	3,818	41,910	22%
Airfare	-	859	3,634	4,770	8,902	9,444	7,191	1,864	2,507	2,714	41,885	22%
Cab Fare/Car Rental	451	859	604	324	555	355	691	594	330	373	5,136	3%
Unclassified	-	-	-	-	1,036	-	-	-	-	-	1,036	1%
Total	**$5,407**	**$7,957**	**$12,399**	**$10,376**	**$24,158**	**$48,833**	**$30,613**	**$14,269**	**$20,543**	**$14,915**	**$189,471**	**100%**

Lodging/Airfare/Spouse Airfare Expenses

As with Messrs. Fuelberg and Burnett, travel related costs appear to comprise approximately half of the expenses incurred by Mr. Dahmann during the period from 1998 – 2007. Meals and other expenses comprised the other half. In addition, the lodging and airfare costs appear to have been incurred primarily in connection with the various NRECA, APPA, CFC and ALDC meetings attended by Mr. Dahmann and others.

Mr. Dahmann also flew on business or first-class airfares a number of times. We identified approximately 32 flights by Mr. Dahmann during the period 1998 – 2007 and approximately half of those flights appear to have been on business or first-class fares. We did not identify any spouse travel in relation to Mr. Dahmann.

Meal and Entertainment Expenses

Mr. Dahmann also used his credit card frequently for meals, including paying for a number of apparent large group meals. However, a majority of the meal expenses incurred by Mr. Dahmann, almost 90%, were less than $100 per transaction. As with Mr. Fuelberg, a small number of large group meals made up the largest portion of the meal expenditures. The breakdown of meal expenses charged by Mr. Dahmann is summarized below:

Summary of Meals for Will Dahmann by Price Range (1998 - 2007)

Price Range	# of Meals	%	Amount	%
$0 - $50	407	73.87%	$ 10,153	19.33%
$50 - $100	85	15.43%	5,700	10.85%
$100 - $500	44	7.99%	9,778	18.62%
$500 - $750	3	0.54%	1,659	3.16%
Over $750	12	2.18%	25,220	48.03%
Total	**551**	**100.00%**	**$ 52,511**	**100.00%**

Based on our analysis, we identified 12 such apparent group meals (>$750) at various well-known high-end restaurants, which are summarized in the following table:

Summary of Meals for Will Dahmann Greater than $750 for 1998 - 2007

Date	Amount	Restaurant	Location	Business Purpose
4/3/2003	$ 3,483.47	Bohanan's	San Antonio	Directors' Workshop
1/27/2004	2,748.51	Morton's of Chicago	San Antonio	Directors' Workshop
8/23/2007	2,310.00	Paesanos Riverwalk	San Antonio	Directors' Workshop
8/2/2004	2,165.65	Little Rhein Steakhouse	San Antonio	TEC Annual Meeting
12/1/1998	2,111.37	Arnaud's Restaurant	New Orleans	NRECA Regional Meeting
2/16/2004	2,071.93	Arnaud's Restaurant	New Orleans	NRECA Annual Meeting
5/12/2004	2,010.70	Little Rhein Steakhouse	San Antonio	Directors' Workshop
8/7/2000	2,003.14	Del Frisco's Double Eagle	Dallas	TEC Annual Meeting
2/17/2005	1,927.71	Waterfront Pub and Eatery	Marble Falls	Directors' Workshop
3/24/2004	1,882.84	Morton's of Chicago	San Antonio	ALDC Meeting
3/10/1999	1,328.74	Charley Brown's	Anaheim, CA	NRECA Annual Meeting
7/22/2002	1,176.36	Oceana Restaurant	New York City	Meeting with Bond Rating Agencies
	$ 25,220.42			

In total, these 12 meals accounted for almost 50% of Mr. Dahmann's meal related expenses. As noted above, in relation to Mr. Fuelberg's large meal related expenses, many, if not most, of the meal expenses paid by Mr. Dahmann appear related to various Directors' workshops or other conferences attended by the Directors and PEC former Senior Management.

Other/Miscellaneous Expenses

Certain other significant expenses were evaluated by obtaining copies of the related credit card statements and underlying invoices and receipts, to the extent they exist. A summary of the other large expenditures included in our analysis is provided in the table below:

Detail of Other Expenses for Will Dahmann for 1998 - 2007

Date	Amount	Vendor	Business Purpose
7/1/2000	$ 1,087	Home Depot	Unknown
5/2/2002	1,948	Outdoor World Houston	Service Award
12/5/2002	13,320	Louis Shanks of Texas	Office Furniture
12/5/2002	5,443	Provencal Home & Garden	Office Furniture (for Jeanell Davis)
12/30/2002	489	132 Main Street	Unknown
12/30/2002	595	Thomas Kinkade Alamo	Artwork
1/23/2003	1,972	Provencal Home & Garden	Office Furniture (for Jeanell Davis)
2/24/2003	1,627	John William Interiors	Cocktail Table (1), End Tables (2)
8/16/2007	2,967	Office Max	Unknown
Total	**$ 29,449**		

C. Observations and Findings

Nonprofit corporations like PEC must properly document expenses incurred in the conduct of the management of the organization's activities to evidence reasonableness and relation to the corporation's mission in serving the needs of its members. With respect to Mr. Fuelberg's expenses, this documentation did not occur. Prior to the current investigation and the disclosure of information produced to the public in connection with the class action lawsuit, no review of Mr. Fuelberg's expenses had been undertaken by either the Cooperative's Finance Manager or the Board, and PEC has never had a consistently maintained internal auditor position. Instead, Mr. Fuelberg exercised sole discretion in determining which expenses he incurred were to be paid or reimbursed by PEC. While PEC had certain expense and travel reimbursement guidelines, the guidelines were generally vague as to authorized expenditure types and amounts. However, Mr. Fuelberg's actions indicate he essentially exempted himself from these policies.

1. Limited Policy and Procedures

As discussed above, the travel expense reimbursement policy at PEC provided little guidance as to what costs were considered to be reasonable and necessary in relation to Cooperative travel, what constituted proper uses of the Cooperative-issued credit cards, and what expenses were properly reimbursable through the expense voucher process. No pre-determined spending limits were set out, nor were there expense levels or ranges, nor any requirement for expenditure authorization or approval, and no established per-diem rates to set a benchmark for reasonable and necessary expenditures for lodging, hotels or meals.

As with most organizations, the tone for expense reimbursement policy was set at the top by Mr. Fuelberg with regard to what was considered a reasonable and necessary business expense versus what might have been considered excessive or even lavish and extravagant. As described, Mr. Fuelberg incurred substantial expenses through his credit card and the expense voucher process, routinely traveling on business and first-class flights, staying at higher-end hotels, hosting large dinners at higher-end restaurants, and purchasing Godiva chocolates for distribution at the office. We were told that Mr. Fuelberg encouraged business and first-class airfare travel for certain of his employees including the Directors, and encouraged spousal travel, citing that "this was a perk" at PEC. Under the tone established by Mr. Fuelberg, there appear to have been few limitations on what was considered an acceptable expense. Based on our review of credit card expenditures by the entire Cooperative during the period under investigation, this tone apparently translated into a credit card and expense reimbursement process where others likewise failed to exercise the type of restraint that might be considered prudent for a member-owned Cooperative.

2. Limited Audit/Review Process

Contrary to well-established internal control principles, backup documentation to support Mr. Fuelberg's expenses either was not provided or was maintained in his office, rather than in the Finance Department. Consequently, the Finance Manager and his staff had no effective mechanism for auditing Mr. Fuelberg's expenses. Mr. Fuelberg's expense records were thus never reviewed or even spot-checked.

There is no evidence that anyone in the Finance Department at PEC ever raised any concerns about Mr. Fuelberg's expense practices or the absence of internal controls in this regard. Raising such concerns about an organization's de facto chief executive officer, while undoubtedly difficult and fraught with personal risk for a subordinate, is nonetheless the correct action for an organization's chief financial officer (CFO). However, as previously described, PEC essentially had no CFO until new management recently appointed the Finance Manager to that position.

In addition to the lack of defined spending limits or guidelines, former Senior Management expenses appear to have been subject to virtually no Board review and no effective audit function . In reality, no one reviewed or ever questioned expenses incurred by former Senior Management. We were told that Mr. Fuelberg's dictum was that if the credit card statement or expense voucher was signed by a manager, then the Finance Department had no reason to review or question the expense. Consistent with this policy, Mr. Fuelberg's own expenditures were unsupported or had inadequate support. Consequently, the Finance Manager and his department were relegated to the role of merely processing the expenses and payments.

As described, there was effectively no Board oversight in reviewing the expenses incurred by former Senior Management. Absent an Audit Committee, the Board effectively had no means or established authority to review and question former Senior Management expenses. This insulation of the expense reimbursement process for Senior Management was apparently a long-standing separation supported by the former General Manager.

3. Lack of Reporting

In addition to the limited transparency into expenses incurred by former Senior Management through the credit cards and the expense voucher process, there appears to have been no reporting mechanism for keeping either the Board or Senior Management informed of the types and amounts of expenditures being incurred by, or on behalf of, Senior Management. While Senior Management-related fees and expenses were paid through PEC's accounts payable process and tracked in PEC's general ledger, former Senior Management, as well as PEC managers, were responsible for their own expense coding. Hence, even if someone was evaluating expenses charged to a particular general ledger account, there was no guarantee, or assurance, that expenses were being recorded to the proper accounts.

4. Questionable Expenses and Abusive Spending by Former Senior Management

The majority of expenses incurred by former Senior Management appear to have been incurred in relation to various sponsored conferences and meetings that were attended by former Senior Management and often by certain of the Directors. The expenses incurred for business and first-class travel raise questions as to their propriety, but there were no express policies precluding either Senior Management or the Board from traveling by business or first-class, nor were there limitations on the higher-end hotels typically selected by Mr. Fuelberg. Nor were there policies or guidelines that applied to the many large group meal expenses incurred, again typically in relation to Directors' workshops and managers' retreats, as well as while on trips associated with the various conferences and meetings.

We noted a number of cases in which Mr. Fuelberg appeared to extend business-related trips, with related incurrence of additional expenses that were paid by the Cooperative. While in some cases we had limited available underlying support (due primarily to Mr. Fuelberg's failure to turn in receipts and invoices in support of his credit card statements), some of these expenses appear to be personal in nature, including certain lodging, meal and per diem related expenses.

Although the apparent abuse of certain travel-related expenditures is of concern, we did not find evidence of any systematic or continued large-scale abuse of the management expense-reimbursement function: all of the expenses reviewed were to some degree related to the conduct of the Cooperative's business, or provided benefit to PEC's former Senior Management, PEC managers, the Directors, or the employees of the Cooperative in a business context.

5. Use of Corporate Credit Cards in Lieu of Purchasing Function

The investigation found evidence of certain large expenditures handled as reimbursements that properly should have been handled through the purchasing or procurement process, in order to ensure that proper controls were followed and that reasonable prices were obtained for the items acquired. Notable among these were purchases, in excess of $10,000, made by Mr. Dahmann for his office furniture. Not only did the Cooperative not have travel and expense guidelines or established spending limits, there also appear to have been very limited spending constraints placed on Cooperative employees in the use of the Cooperative- issued credit cards. Mr. Dahmann's expense, as well as others that could be cited, was of such significant magnitude that it should have been subject to a more formal process involving the Finance Manager and his department, as well as, potentially, the purchasing and/or the fixed assets group, in order to ensure that prices were reasonable and appropriate and that proper approvals were obtained.

6. Potential Tax Implications

The federal Tax code requires that travel expenses not be "lavish or extravagant under the circumstances," though "lavish" and "extravagant" remain undefined in the tax code or in regulations.[393] Travel expenses that are paid or reimbursed but not properly documented or that can be characterized as "lavish or extravagant" in nature are treated as taxable compensation to the individual so benefiting. In addition, the payment of travel for an employee's spouse may also be treated as taxable compensation. The IRS has provided detailed guidance for managers in avoiding lavish, extravagant or excessive expenditures.[394] However, even the IRS guidelines state:

> *"An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts."*

When an employer pays the travel expenses of an employee's spouse who travels with the employee on official business, the benefit is excludable from tax only if the spouse performs a bona fide business function on the trip. To the extent that there is no business purpose for the spouse's travel, the spousal travel expenses paid by the employer are includable in the employee's taxable income, and reportable on that employee's Form W-2 and on a tax-exempt organization's Form 990.

The courts have used a two-part analysis in determining whether a spouse has satisfied the business purpose test: 1) the dominant purpose of the spouse's travel must serve the employer's business, and 2) the spouse must actually spend a substantial amount of time assisting the accomplishment of the employer's purpose. The performance of simply "social function[s]" does not satisfy the business purpose test. When spousal travel is taxable income to the employee but the organization has not treated it as such, such payment may be treated as an "automatic excess benefit" transaction subject to certain potential penalties. Therefore, to ensure that no excess benefit transactions have taken place, spousal travel should be reviewed to determine whether it satisfies the described business purpose test.

7. Evaluation of Expenses – Reasonable and Necessary

As noted above, no provision in the PEC Bylaws and no prescribed expense policy governed expenses by PEC Directors or Senior Management. In fact, many, if not most, of the expenses

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[393] Code § 162(a)(2); Treas. Reg. §§ 1.162-2, 1.162-17.

[394] IRS Publication 463, Travel, Entertainment, Gift and Car Expenses (2008).

reimbursed to former Senior Management or paid through Cooperative-issued credit cards appear to have been in relation to various meetings, conferences and workshops they attended. However, the frequency and pattern of expenses that exceeded other reasonable and/or prudent alternatives appears to be significant, especially in relation to lodging, first and business class airfare, and certain group meals.

In evaluating PEC former Senior Management expenses, the distinction between expenses deemed reasonable and necessary, versus excessive, is largely subjective. However, while reasonable explanations and motivations likely exist for a number of the expenditures, in reality the expense practices at PEC and on behalf of former Senior Management went largely unchecked. In addition, without adequate reporting, the Directors were likely left with only a vague understanding as to the magnitude of the expenses incurred by former Senior Management.

D. Recommendations

Navigant Consulting suggests a number of policy related recommendations to improve the effectiveness and oversight of the Board's and management's evaluation of Senior Management expenses and the expense reimbursement process.

Travel Expense Reimbursement Policy

- As previously described, at the direction of the new PEC General Manager, PEC instituted a *Travel Expense Reimbursement Policy* applicable to both PEC employees and the Board.[395] The expense policy is specifically targeted at travel involving an overnight stay and/or airline travel, with the remaining expense reimbursement procedures for mileage, meals and other incidentals handled through a reimbursement of actual expenses incurred. Navigant Consulting considers the adoption of this policy to be appropriate.

Board Expense Audit and Review Process

- The new expense reimbursement policy requires the Board Expense Audit Committee to review and approve Board-related expenditures, including responsibility for verifying that the stated purpose of travel is valid and related to official Cooperative business, expenditures are in accordance with the newly established policy, and required backup support documentation has been provided and that it is accurate and complete. Navigant Consulting recommends that the Expense Audit Committee also be tasked with the periodic review of Senior Management expenses, at least periodically, to ensure that Senior Management is complying with the travel expense reimbursement policy.

Finance Department Expense Audit and Review Process

- It is recommended that Senior Management, as well as all employee expenses, be subject to review, evaluation and audit by the Finance Department. This review should entail ensuring that all expenses are properly approved, coded and supported by underlying invoices and receipts as required by the Cooperative's policies and procedures. The designated reviewers should have the authority to deny reimbursement of certain expenses unless they are

[395] Travel Expense Reimbursement Policy, Pedernales Electric Cooperative, Inc., Board Adopted: March 17, 2008.

satisfied that the established policies and procedures are met. An expense limit should also be established for expense items exceeding a certain dollar amount, with higher-level approval being required, including approval by the CFO or General Manager.

- Navigant Consulting also recommends that certain types of expenditures should not be permissible through the Cooperative-issued credit cards or expense voucher process, unless otherwise approved by senior management. These defined types of expenditures should be specified as subject to processing only through the Cooperative's purchasing and procurement procedure.

Management and Board Reports on Expenses

- The Board members apparently had no opportunity to express judgments about the expense practices engaged in by the former General Manager; this was in part because they had little information about these practices, and they did not insist on receiving such information. Likewise, they had little apparent sensitivity to what the public perception by Cooperative members might have been had the travel-related expenses of PEC former Senior Management been known. It is recommended that management develop a periodic report for purposes of informing the Board of the expenses practices of senior management, as well as the Board.

XVIII. Public Disclosures – Form 990

A. Background

1. Form 990 – Return of Organization Exempt From Income Tax

Electric Cooperatives exempt from taxation under section 501(c)(12) of the Internal Revenue Code are required to file a Form 990, Return of Organization Exempt From Income Tax ("Form 990").[396] Form 990s are used by tax-exempt organizations to provide the Internal Revenue Service ("IRS") with the information required by section 6033 of the United States Code, including gross income, receipts and disbursements, and other information about the organization's finances and operations.[397] The Form 990 serves as the primary document providing information about the organization's finances, governance, operations, and programs for federal and state regulators, the public, and a cooperative's members. The instructions for completing the Form 990 state:[398]

> *"Some members of the public rely on Form 990…, as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its return. Therefore, the return must be complete, accurate, and fully describe the organization's programs and accomplishments."*

Among other items, electric cooperatives are required to report compensation and other information regarding their Directors, officers, and key employees in Part V of the Form 990. Part V of the Form 990 requires cooperatives to "list each person who was a current officer, Director, trustee, or key employee… of the organization" including the individual's compensation, contributions to employee benefit plans and deferred compensation plans, expense account and other allowances, and any loans or advances made to the individual.[399] The definition of a key employee on the 2006 and 2007 Form 990 instructions states:

> *"A key employee is any person having responsibilities, powers, or influence similar to those of officers, Directors, or trustees. The term includes the chief management and administrative officials of an organization (such as an executive Director or chancellor.)*
>
> *A chief financial officer and the officer in charge of the administration or program operations are both key employees if they have the authority to control the organization's activities, its finances or both."* [400]

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[396] NRECA Legal Reporting Service Article titled "Reporting Director, officer, and Key Employee Compensation Information on Form 990" dated May 2007; 2007 Instructions for Form 990 and Form 990-EZ, p. 1, 4.
[397] United States Code TITLE 26 - Subtitle F - CHAPTER 61 - Subchapter A - PART III - Subpart A - § 6033 Returns by exempt organizations.
[398] 2007 Instructions for Form 990 and Form 990-EZ, p. 1.
[399] 2007 Instructions for Form 990 and Form 990-EZ, p. 40.
[400] 2006 Instructions for Form 990 and Form 990-EZ, p. 34; 2007 Instructions for Form 990 and Form 990-EZ, p. 40.

The definition of a "key employee" in the instructions for Part V of the Form 990 during the period 1998 – 2004 included additional detail related to the managers of separate departments. The instructions state:[401]

> *"A key employee… does not include the heads of separate departments or smaller units within an organization.*
>
> *The 'heads of separate departments' reference applies to persons… [that] are managers within their specific areas but not for the organization as a whole and, therefore, are not key employees."*

The definition of a "key employee" on the 2005 Form 990 instructions included only part of the definition contained in the 2006 and 2007 Form 990 instructions. The 2005 Form 990 instructions state:[402]

> *"A key employee is any person having responsibilities, powers, or influence similar to those of officers, Directors, or trustees. The term includes the chief management and administrative officials of an organization (such as an executive Director or chancellor.)"*

The instructions for Part V of the Form 990 during the period 1998 – 2007 also required that certain deferred compensation for key employees be included on the Form 990. The 2007 Form 990 instructions for "Column (D)" state:

> *"Include in this column all forms of deferred compensation and future severance payments (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under section 401(a)). Include also payments to welfare benefit plans on behalf of the officers, Directors, etc. Such plans provide benefits such as medical, dental, life insurance, severance pay, disability, etc. Reasonable estimates may be used if precise cost figures are not readily available.*
>
> *Unless the amounts were reported in column (C), report, as deferred compensation in column (D), salaries and other compensation earned during the reporting period, but not yet paid by the date the organization files its return."*[403]

2. PEC's Form 990 Filings

PEC filed Form 990 each year during the period under investigation (1998 – 2007). It is our understanding that the PEC practice was for KPMG, PEC's outside auditor, to complete the Form 990

[401] 1998 – 2004 Instructions for Form 990 and Form 990-EZ.

[402] 2005 Instructions for Form 990 and Form 990-EZ, p. 28.

[403] 2006 and 2007 Instructions for Form 990 and Form 990-EZ. The Form 990 instructions for column (D) for the period 1998 – 2005 contain minor differences compared to the Form 990 instructions for column (D) for the period 2006 – 2007. The Form 990 instructions for column (D) 1998 – 2005 excludes the word "directors" in the sentence, "Include also payments to welfare benefit plans on behalf of the officers, directors, etc."

based on information provided by the Cooperative, and that KPMG also provided advice to PEC on certain questions related to the Form 990. The PEC Finance Manager typically signed the Form 990 as the "officer" of the entity and KPMG, signed the Form 990 as the "paid preparer" during the period 1998 – 2007.

PEC reported information relating to the Directors, including the compensation and other benefits they received, in Part V of the Form 990 for the period 1998 – 2007. However, PEC did not report in Part V any compensation information for the General Manager and other Senior Management personnel, including the Assistant General Manager during the period 1998 – 2005. PEC did report such information for the General Manager and Assistant General Manager in Part V of the Form 990 in 2006 and 2007. It is our understanding that this information was reported on the 2006 and 2007 Form 990 submittals (filed in November 2007 and May 2008).

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and reviewing PEC's Form 990 filings for the period 1998 – 2007 including evaluating whether PEC failed to include certain information related to the former General Manager and Assistant General Manager, as well as determining whether the information provided with regard to PEC's Directors was accurate and complete.

More specifically, the scope of our work included the following:

- Identifying and reviewing applicable IRS filing standards and instructions for completing Form 990 filings.
- Reviewing and analyzing PEC Form 990 filings for the period 1998 – 2007.
- Identifying and reviewing Form 990 filings for the nine largest electric cooperatives in Texas and the twenty largest electric cooperatives in the United States including disclosures related to senior management compensation.
- Reviewing and analyzing electronic and hard-copy files and information retained by PEC related to the Form 990 filings.
- Analyzing Director and Senior Management compensation and benefits including certain expenses incurred on their behalf, and appropriately treated as income, for the period 1998 – 2007.
- Reviewing and evaluating schedules prepared by PEC supporting proposed restated figures for the Form 990 for the period 2004 – 2007.

- Conducting interviews and discussions with Cooperative personnel regarding the Form 990 filings.

C. Observations and Findings

1. Failure to Report Mr. Fuelberg as a Key Employee

PEC did not identify as key employees and report relevant information for the General Manager and the Assistant General Manager in Part V of the Form 990 during the period 1998 – 2005. Based on our review of the pertinent information, it appears that PEC, at a minimum, should have included the General Manager as a "key employee" under the definition of key employee applicable during the period 1998 – 2005. It is our understanding that Mr. Fuelberg did not want to be included on the Form 990. We were told by PEC's current CFO that PEC consulted with KPMG regarding PEC's decision of whether or not to include Mr. Fuelberg as a key employee on the Form 990.

2. Potential Failure to Report Mr. Burnett's Retirement Obligations

For the 2001 to 2006 period, PEC's Form 990 filing did not include the additional monthly retirement payments payable to Mr. Burnett in his role as "Employee Coordinator" and Director, to which he would be entitled upon his retirement from the Cooperative. As described in a previous section of this Report, a December 2001 Board resolution essentially obligated PEC to make an additional retirement payment to Mr. Burnett from the Cooperative's general operating fund based on his years of service as a Board member prior to his employment as Coordinator. PEC did not recognize a liability for Mr. Burnett until he retired in 2007. However, a question exists as to whether PEC should have recognized the obligation to Mr. Burnett at the time of the Board resolution in 2001.

3. Industry Guidance on Form 990 Reporting Requirements

A May 2007 National Rural Electric Cooperative Association ("NRECA") article addresses reporting Director, officer, and key employee compensation information on Form 990. The article states:

> *"When completing its Form 990, a cooperative must list 'all' Directors, officers, and key employees of itself and any disregarded entity."*
>
> *"A key employee is 'any person having responsibilities of powers similar to those of officers, Directors, or trustees.' A cooperative's 'chief management and administrative officials' are key employees. If a cooperative's chief financial and operating officers are authorized to control the cooperative's finances and/or activities, then they are key employees. At a minimum, it seems a cooperative's General Manager or chief executive officer is a key employee. Most cooperative chief financial and operating officers are probably key employees."*[404]

[404] NRECA Legal Reporting Service Article titled "Reporting Director, Officer, and Key Employee Compensation Information on Form 990," May 2007.

4. Form 990 Reporting Practices for Other Cooperatives

We reviewed the most recently available (2005 or 2006) Form 990 for the twenty largest cooperatives in the United States based on asset size (excluding PEC) and found that eighteen of these included the organization's General Manager or chief executive officer ("CEO") as a key employee for Form 990 reporting purposes and disclosed the General Manager's or CEO's compensation.[405]

In addition we reviewed the most recently available (2005 or 2006) Form 990 for the nine largest cooperatives in Texas based on asset size (excluding PEC) and identified that all nine included the organization's General Manager or CEO as a key employee for Form 990 reporting purposes and disclosed the General Manager's or CEO's compensation.[406]

5. Other Form 990 Reporting Requirements

In addition to PEC's failure to report the compensation for the former General Manager and the Cooperative's former (i.e. Retired, Honorary and Emeritus) Directors on the 1998 through 2005 Form 990, PEC also may have failed to report certain benefits received by the Directors. PEC's 2005 and 2006 Form 990 submittals did not include any of the benefits received by former Directors and their spouses.[407] As described in other sections of this Report, former Directors and their spouses or widows received health and dental insurance benefits from PEC. In addition, PEC did not disclose certain benefits received by Directors, including travel costs paid by PEC for the Director's spouses and Cooper Clinic expenses incurred by Directors and their spouses.

D. Recommendations

Evaluate Form 990 Reporting Process and Need for Restatement

- It is recommended that PEC evaluate its current Form 990 reporting process and determine whether there is a need to restate certain Form 990 submittals for prior years in order to properly disclose required information, including the key employee status of the former General Manager and his related compensation and benefits.

- Navigant Consulting also recommends that PEC seek advice from tax professionals to ensure accurate Form 990 reporting for any restated Form 990 submittals and any future Form 990 filings.

[405] Summary of CEO Compensation Survey. One cooperative is included in both the largest U.S. cooperative group as well as the largest Texas cooperative group.
[406] Summary of CEO Compensation Survey. One cooperative is included in both the largest U.S. cooperative group as well as the largest Texas cooperative group.
[407] It is our understanding that the Form 990 instructions applicable during the period 1998 – 2004 did not require the disclosure of compensation and benefits paid to former officers, directors and key employees.

XIX. Related Parties – Moursund Family Interests

A. Background

Throughout the course of the class action lawsuit, as well as during the investigation, questions were raised regarding relationships between PEC and certain individuals and entities in connection with potential conflicts of interest that may have existed. Included in these are questions regarding PEC's long-standing relationship with the Moursund family and various business interests controlled by the family.

A.W. Moursund had served as General Counsel for the Cooperative for many years, as both a full-time employee (1951 – 1984) and as an outside service provider through retainer (1984 – 2002). A.W. Moursund's role as General Counsel was assumed by his son, Will Moursund, and the family law firm, Moursund, Moursund & Moursund ("Moursund Law Firm") following A.W. Moursund's death in 2002. In addition, PEC also received services over the years through various Moursund controlled business interests including Cattleman's National Bank ("Cattleman's") and the Moursund Insurance Agency, among others (collectively referred to as the "Moursund-related entities").

B. Work Performed

1. Scope of Work

Included in the scope of Navigant Consulting's work was an evaluation and analysis of PEC's past relationship with A.W. Moursund and the various Moursund-related entities, as well as the circumstances surrounding the retention of services from the Moursund-related entities and the amount paid for those services. Our investigation focused on the following relationships covering the period from 1988 to 2007:[408]

- A.W. Moursund
- The Moursund Law Firm
- Cattleman's National Bank
- Moursund Insurance Agency
- Moursund Land Titles, Inc.
- Moursund Abstract Co.

More specifically, the scope of our work included the following:

- Performing detailed searches of publicly available information including searches of public filings with the Texas Secretary of State to identify Moursund-related entities.

[408] As of result of questions arising from the existence of the Texland Electric Cooperative, Inc. bank account at Cattleman's National Bank, and the Moursund family's controlling interest in Cattleman's, the scope of our investigation into the Moursund-related entities was extended back to 1988 and, where information was available, back to the formation of Texland in 1979.

- Reviewing and analyzing electronic and hard-copy files and information retained by PEC including searches of PEC's EDMS database for relevant information.

- Identifying relevant information regarding compensation and benefits provided to A.W. Moursund and the Moursund Law Firm including Form W-2s and various payroll, wage history and/or labor distribution reports, as well as Form 1099 submittals.

- Identifying available human resources information including relevant information related to A.W. Moursund's personnel file, employment history, employment agreements, payroll change authorizations, and time sheets.

- Identifying applicable defined benefit retirement, pension, and deferred compensation plans for Mr. Moursund, as well as health/dental and group life insurance benefits.

- Identifying relevant PEC general ledger accounts in which compensation, bonus and other fee-for-service and commissions payments were booked and reconciliation of those amounts to reported compensation on the respective Form 1099.

- Preparing schedules summarizing the annual salary, retainer, bonus, retirement plan contributions and other payments received by A.W. Moursund at various points during his tenure as General Counsel, as well as the Moursund Law Firm from 1988 – 2007.

- Preparing schedules summarizing the total fee-for-service, retainer, and commission payments received by Moursund-related entities including the Moursund Law Firm, Cattleman's National Bank, and Moursund Insurance Agency from 1988 – 2007.

- Preparing detailed chronologies and histories regarding the circumstances surrounding the changes to the annual salary, retainer, bonus, retirement plan contributions and other payments received by A.W. Moursund and the Moursund Law Firm.

- Identifying Board resolutions and corresponding authorizations for changes in payments and business conducted with A.W. Moursund and the Moursund-related entities.

- Evaluating services provided by the Moursund Insurance Agency with regard to the Cooperative's insurance programs.

- Evaluating PEC's history with Cattleman's National Bank, including the amount of funds routinely collected through the various Cooperative customer accounts held at Cattleman's.

- Interviewing current and former PEC personnel to gain a better understanding of services provided by A.W. Moursund and the Moursund-related entities.

- Analyzing various compensation and fee-for-service payments paid to A.W. Moursund, the Moursund Law Firm and other Moursund-related entities relative to the services provided.

- Investigating electric service and costs of service provided to various Moursund-related entities that were also customers of PEC during the period 1998 – 2007.

2. History of A.W. Moursund's Relationship with PEC

A.W. Moursund (or "Judge Moursund" as he was commonly known) was described as a lawyer, rancher, banker and County Judge in the Texas hill country.[409] He was the owner of various businesses during his lifetime including the Moursund Law Firm, Arrowhead Bank in Llano, Texas, Cattleman's National Bank in Round Mountain, Texas, the Moursund Insurance Agency, and various other land and ranching related business. He served in the Texas House of Representatives from 1948 to 1952 and as a County Judge in Blanco County from 1953 to 1959. He had significant ties to many of the most notable politicians in the State of Texas during his long career including Lyndon Baines Johnson (LBJ), John Connally (former Governor of Texas) and Bob Bullock (former Lieutenant Governor of Texas). In addition, Judge Moursund, working in association with John Connally and LBJ, is accredited with bringing electricity to much of rural central Texas.

Judge Moursund was affiliated with PEC from 1950 until his death in 2002. He was employed by PEC as General Counsel from 1951 until his retirement on August 1, 1984.[410] However, and simultaneous with his retirement as General Counsel, Judge Moursund was "retained by the Cooperative as General Counsel" on a contract basis. At various times the Board reaffirmed Judge Moursund's continued service as General Counsel through various Board resolutions over the years.[411,412]

Judge Moursund remained as individual General Counsel to PEC until October 2000 when the Board authorized "that at Judge Moursund's request, his employment as individual General Counsel be changed to Moursund, Moursund and Moursund as General Counsel at the same amount remunerated as is presently received by him individually."[413] At the time, the Moursund Law Firm consisted of A.W. Moursund, his son Will Moursund, and either daughter Mary Moursund or daughter-in-law Ingrid Moursund. However, despite the apparent change in October 2000, Judge Moursund continued to attend PEC Board meetings, acting in a capacity essentially that of General Counsel until his death in 2002. Will Moursund, as well as other members of the Moursund family, began regularly attending PEC Board meetings after 2000.

Following Judge Moursund's death on April 22, 2002, the Moursund Law Firm assumed the role as PEC's General Counsel with Will Moursund, Judge Moursund's son, serving as the primary contact.[414]

[409] Obituary for Albert Wadel Moursund, III, San Antonio Express News, April 24, 2002.
[410] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 16, 1984.
[411] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 15, 1991.
[412] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 20, 1998.
[413] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 23, 2000.
[414] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 15, 2002 and Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.

Over the years, Judge Moursund and the Moursund family have received significant compensation from PEC, including compensation for Judge Moursund's employment and retainer as General Counsel, payments to the Moursund Law Firm, payments for services as the PEC's Board's Secretary, and payments to the Moursund Abstract Co., Moursund Land Titles, Inc. and Moursund Insurance Agency. Over the past twenty years, it is estimated that the Moursund family has received in excess of $4.3 million from PEC, and likely significantly higher amounts as the information obtained through PEC had relatively little detail with regard to the amount of commission payments made to the Moursund Insurance Agency. A detailed summary of payments and estimated payments to Judge Moursund and other Moursund-related entities over the past twenty years is provided in Exhibit 32.

3. A.W. Moursund Compensation and Benefits: 1988 - 2002

Judge Moursund was paid as an employee of the Cooperative from 1951 until his retirement in 1984, and then as an independent contractor through a retainer from 1984 until his death in 2002. In addition, Judge Moursund received annual bonuses from the Cooperative from at least 1984 through the first half of 2001, as well as payments from the Cooperative's retirement plan that began in 1984. Certain payments to Judge Moursund and Moursund-related entities prior to 1988 are addressed in relation to the Texland venture, which are described in an earlier section of this Report. A summary of payments to Judge Moursund from 1988 – 2002 is provided in the table below:

Summary of Payments to A.W. Moursund (1988 - 2002)

Payee	1988	1989	1990	1991	1992	1993	1994	1995
A. W. Moursund - Retainer	$138,333	$138,594	$134,953	$137,148	$139,549	$141,264	$141,264	$141,264
A. W. Moursund - Bonus	15,000	15,000	20,000	20,000	24,115	27,063	20,000	35,000
Board Secretarial Services	-	-	-	8,400	14,400	14,400	14,400	14,400
A. W. Moursund - Retirement	26,846	26,846	26,846	26,846	26,846	26,846	32,351	32,351
	$180,179	**$180,440**	**$181,799**	**$192,394**	**$204,910**	**$209,574**	**$208,016**	**$223,016**
Payee	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**Total 1988 - 2002**
A. W. Moursund - Retainer	$141,264	$141,264	$141,264	$141,264	$141,264	$176,264	$50,316	$2,045,273
A. W. Moursund - Bonus	40,000	45,000	50,000	50,000	60,000	30,000	-	451,178
Board Secretarial Services	14,400	14,400	14,400	14,400	14,400	14,400	3,600	156,000
A. W. Moursund - Retirement	32,351	32,351	32,351	32,351	32,351	37,527	15,636	440,698
	$228,016	**$233,016**	**$238,016**	**$238,016**	**$248,016**	**$258,191**	**$69,552**	**$3,093,148**

Monthly Retainer

Judge Moursund "retired as an employee of the Cooperative, effective August 1, 1984."[415] Upon his retirement, Judge Moursund began receiving a retainer of $5,812 per month (approximately $70,000 per year) from the Cooperative for continued service as PEC's General Counsel. Prior to that time, Judge Moursund had been a full-time employee of the Cooperative with a monthly salary of approximately $4,240.[416]

[415] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 16, 1984.

[416] Letter to Mr. Will P. Martin from Ronald W. Tobleman, Rudd and Wisdom, Inc., January 31, 1983.

The basis for Judge Moursund's retirement in 1984 is not known. However, the change appears to have been only in employment status (i.e., from employee to independent contractor), as Judge Moursund continued in the role as PEC's General Counsel. In addition, during the early to mid-1980s Judge Moursund was also being paid a retainer from Texland Electric Cooperative, Inc., both while he was a PEC employee, as well as after his change from a salaried employee to an independent contractor.

By 1987, the retainer paid to Judge Moursund had increased from $5,812 to $7,225 per month. Effective January 1988, Judge Moursund's retainer was again increased, by over 40% from $7,225 to $10,416 per month.[417] His retainer was increased several other times between 1988 and 2002, but the most significant was a September 2001 increase from $11,772 per month to $16,772 per month.[418] The September 2001 increase was pursuant to a Board-approved resolution authorizing an increase in the monthly retainer for Judge Moursund by $5,000 per month. This increase was similar to that approved at the same time for Messrs. Fuelberg and Burnett, with all of these increases being described as payments in lieu of the semi-annual bonus payments previously received by each. The resolution was made retroactive to July 1, 2001. A list of the annual retainer amounts paid to Judge Moursund is attached as Exhibit 33.

Bonus Payments

Judge Moursund also received various annual bonus payments from PEC. In addition, beginning in 1995, Judge Moursund appears to have received semi-annual bonuses from the Board, one at mid-year around the time of the annual meeting and one at year-end, typically in December. As an example, Judge Moursund was paid two $25,000 bonuses in 1998 and 1999, and two $30,000 bonuses in 2000. He was also paid a $30,000 bonus in the first half of 2001 before the $5,000 increase in his retainer in September 2001, which, as described, was paid in place of the periodic bonuses. In effect, while Judge Moursund received a $60,000 raise in his retainer through the September 2001 Board resolution, he had been receiving semi-annual bonuses of $30,000 over the previous year and one-half, and two $25,000 bonuses for several years before that. A list of the annual and semi-annual bonus amounts paid to Judge Moursund is attached as Exhibit 34.

Board Secretarial Services

Judge Moursund received another $1,200 payment per month ($14,400 annually) for providing secretarial services to the Board. Judge Moursund apparently assumed the responsibility of Board Secretary in 1991 after the retirement of Hilda Kroll.[419] Judge Moursund, followed by the Moursund Law Firm, was paid a consistent $1,200 per month fee from 1991 until the termination of the firm's services to PEC in 2008. A list of the monthly Board Secretarial service fees paid initially to Judge Moursund, and subsequently to the Moursund Law Firm, is attached as Exhibit 35.

Retirement and Benefits

Based on his years of employment at the Cooperative from approximately 1950 to 1984, Judge Moursund qualified for monthly payments from PEC's existing "Retirement Plan." Judge Moursund

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[417] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 21, 1987.
[418] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 21, 1987.
[419] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., September 17, 2001.

began receiving a monthly payment of $2,237.18 in August 1984.[420,421] His monthly retirement payment was increased to $2,695.92 in 1993 as a result of the PEC Board's action increasing "the monthly benefits…being paid to retirees and beneficiaries of the PEC Retirement Plan."[422] Judge Moursund's monthly retirement payment was increased again in 2001 to $3,127.27 by a similar action of the PEC Board.[423]

Judge Moursund also appears to have participated in two other supplemental retirement programs at the Cooperative. One of the programs appears to have been a Defined Contribution Plan or Savings Plan.[424] A.W. Moursund received a lump sum payment of approximately $70,000 in 1984 upon his retirement for his participation in this program. The other program appears to have been a supplemental compensation program that was created in 1974.[425] Upon retirement, A.W. Moursund received a monthly payment of $20 from this program until his death in April 2002.[426] The records available for these two other supplemental retirement programs are limited.

In addition, it appears that the Cooperative provided health benefits for Judge Moursund and his wife from his retirement date in 1984 until 1988, after which it continued providing dental coverage. The dental premium was approximately $50 per month in 2002.[427]

4. History of Relationship with the Moursund Law Firm

The Moursund Law Firm officially became PEC's General Counsel in or around October 2000 when Judge Moursund requested that "his employment as individual General Counsel be changed to Moursund, Moursund & Moursund as General Counsel at the same amount as enumerated as is presently received by him individually."[428] However, as referred to above, it appears that Judge Moursund effectively functioned as General Counsel until his death in 2002.

Upon Judge Moursund's death, the PEC Board officially recognized the retention of the Moursund Law Firm in a Board resolution dated May 2002 stating:

> *Resolved by the Board of Directors of the Cooperative, that the firm of Moursund, Moursund, & Moursund continue to be retained as counsel for the Cooperative to perform the tasks of bad debt collection, real estate advice and closure, liability insurance procurement, and such other civil actions and tasks as may from time to time be authorized by Board Resolution or assigned by the General Manager.*[429,430]

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420 Letter from Texas Commerce Bank to A.W. Moursund, September 7, 1984.
421 Certification and Election of Retirement Benefits for A.W. Moursund.
422 Letter from Bennie Fuelberg to A.W. Moursund, December 27, 1993.
423 Letter from Nickie Cox to A.W. Moursund, December 10, 2001
424 Letter from Texas Commerce Bank to A.W. Moursund, September 7, 1984.
425 Letter from E. Babe Smith to Judge Moursund, September 16, 1974.
426 Letter from Mrs. La Vonne Bench to Mr. A.W. Moursund, The Bankers Life, Re: Pedernales Electric Cooperative, Inc., October 12, 1984.
427 Pedernales Electric Cooperative, Inc. – Summary of Director's Benefits 2002.
428 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., October 23, 2000.
429 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.

From 2002 through 2007, the Moursund Law Firm appears to have continued providing services in relation to PEC's delinquent consumer accounts. In addition, services were routinely provided to PEC in obtaining its liability insurance through the Moursund Insurance Agency. Other services in relation to "real estate advice and closure" appear to have been rather limited noting only certain fees paid to Moursund Land Titles, Inc., and several instances in which the Moursund Law Firm would receive "document preparation fee(s)" ranging from $125 - $250 that were paid by sellers at closing.

5. Moursund Law Firm Compensation: 2002 – 2007

The Moursund Law Firm, in lieu of Judge Moursund, continued to be paid the monthly retainer of $16,772 ($201,264 annually) from 2002 – 2007.[431] In addition, the $1,200 monthly payment for furnishing secretarial services to the Board also continued to be paid through 2007. A summary of payments received by the Moursund Law Firm from 2002 – 2007 is summarized in the table below:

Summary of Payments to Moursund Law Firm (2002 - 2007)

Payee	2002	2003	2004	2005	2006	2007	Total
Moursund Law Firm - Retainer	$150,948	$184,492	$201,264	$201,264	$201,264	$201,264	**$1,140,499**
Board Secretarial Services	10,800	13,200	14,400	14,400	14,400	14,400	**81,600**
	$161,748	**$197,692**	**$215,664**	**$215,664**	**$215,664**	**$215,664**	**$1,222,099**

A list of the annual retainer amounts paid to the Moursund Law Firm is attached as Exhibit 36.

6. Payments to the Moursund Insurance Agency

The Moursund Insurance Agency has provided insurance services to PEC as a broker since approximately 1979. The Moursund Insurance Agency maintains an office in Round Mountain, Texas with Jay Frasier serving as the Moursund Insurance Agency representative and broker to PEC over the past few years. The Moursund Insurance Agency has been PEC's only insurance agent during the ten years of the investigation period, and it does not appear that PEC ever solicited information or policy premium bids from other insurance agents during this time period.[432]

Serving as a broker, the Moursund Insurance Agency appears to have routinely presented several policy options to PEC for each insurance policy (e.g., quotes from AIG, State Farm, and Travelers for Commercial Auto Insurance, etc.). While this process allowed PEC to select a low cost premium for each insurance policy based on the coverage provided, the process did not allow PEC to evaluate insurance policy or brokerage costs exclusive of the commission payments received by the Moursund Insurance Agency that were typically embedded in the cost of the premiums.

[430] This Board Resolution was reaffirmed by a September 19, 2005 Board Resolution.
[431] This is the same retainer payment that A.W. Moursund received from Pedernales Electric Cooperative, Inc.
[432] The Moursund Insurance Agency co-brokers several policies with Carol Griffin from Powell & Meadows and one policy with Blais Excess & Surplus Agency of Texas.

The Moursund Insurance Agency was compensated on a commission basis under which it received a percentage of each insurance policy premium. In many cases, we have been unable to determine the precise commission paid to the Moursund Insurance Agency because the premiums typically included, without separate breakout, the commission payments negotiated between the Moursund Insurance Agency and the insurance carrier. The commission percentage was not historically disclosed to PEC, a practice which, based on our general understanding, is not uncommon in the insurance industry.

Historically, PEC would either pay the insurance policy premium directly to the insurance carrier, which would separately pay the Moursund Insurance Agency's commission, or the policy premium would be paid by PEC to the Moursund Insurance Agency, which would retain its commission before forwarding premium payments to the respective insurance companies.[433] Based on limited available information, the amount of commission payments made to the Moursund Insurance Agency with respect to the various policies is estimated to be between $225,000 - $250,000 in 2007.

In addition, as previously noted, Mr. Frasier, PEC's representative contact with the Moursund Insurance Agency, in recent years also received the Cattleman's National Bank statements for the Texland account that were sent from PEC to Rory Boatright "care of" Jay Frasier. Mr. Frasier's involvement with Texland is addressed in greater detail in a previous section of this Report.

7. Payment to Moursund Land Titles, Inc. and Moursund Abstract Company

Based on the hard-copy and electronic information reviewed and interviews conducted throughout the investigation, we were able to determine that the Moursund Land Titles and the Moursund Abstract Company (collectively "Moursund Real Estate Companies") provided limited services to PEC during the 1988 – 2007 time period.[434]

PEC's general ledger indicates ten payments totaling approximately $456,000 were made to the Moursund Abstract Company during the 1988 – 2001 time period, and an additional three payments were made to Moursund Land Titles, Inc. totaling approximately $22,000 during 2005 and 2006. Based on the description in the PEC general ledger, it appears that these payments related to "land," "real estate," "property," or "title work" and that they do not necessarily represent amounts paid to the Moursund Abstract Company as compensation. In certain situations, these amounts may relate to a deposit of escrow money.

Based on information provided, it appears that PEC was involved in approximately 29 real estate transactions during the 1998 – 2007 time period. Throughout the course of the investigation, we requested detailed information for approximately ten of these real estate transactions including settlement statements, appraisals, and other supporting documentation where available. The Moursund Abstract Company served as the settlement agent on certain of these real estate transactions. In addition, the Moursund Abstract Company received the deposit or escrow money in certain transactions in which it served as the settlement agent. However, it appears that in certain

[433] Based on 2007 commission rates provided by the Moursund Insurance Agency.
[434] We have not requested records related to real estate transactions prior to 1998.

situations, the Moursund Abstract Company also received the deposit or escrow money in the transactions for which it was not the settlement agent.

In addition, Moursund Abstract Company appears to have been paid in relation to certain real estate transactions in which PEC was a party, but for which the payments, by their nature, were not reflected in PEC's general ledger. In one instance, the Moursund Abstract Company received a fee ($217) from the seller for providing title insurance with regard to certain property acquired by PEC. Moursund Abstract Company also received a fee ($5,287) from the buyer (PEC) for title insurance when PEC purchased the River Palace in Johnson City in 2004. These closing-related fees were not specifically denoted as payments to the Moursund Abstract Company in PEC's general ledger.

Based on the information provided, it appears that many of the payments identified in the general ledger to the Moursund Real Estate Companies may be for deposit or earnest monies for real estate transactions and as such would not constitute compensation to the Moursund Real Estate Companies. However, as described above, it appears that the Moursund Real Estate Companies were receiving compensation in certain transactions through the settlement statement for document preparation fees or title insurance in addition to the monthly retainer. However, it appears that this amount was negligible during the period 1998 – 2007.

8. Texland and Judge Moursund

As described, Judge Moursund was also involved in the Texland venture. Judge Moursund served as General Counsel for Texland and received a $6,000 monthly retainer from 1980 – 1987 for a total of $546,000. In addition, Judge Moursund received a $150,000 lump sum payment in 1988 for his services related to Texland's settlement with the LCRA and negotiations with Shearson Lehman. Judge Moursund's involvement with Texland is addressed in greater detail in a previous section of this Report.

9. Judge Moursund, PEC and Cattleman's National Bank

Cattleman's National Bank ("Cattleman's") was established in June, 1986 by A.W. Moursund.[435] It is our understanding that Judge Moursund was the majority owner of Cattleman's prior to his death and that the Moursund family is now the majority owner. Will Moursund is currently the Chairman of the Board of Cattleman's with Ingrid and Mary Moursund serving as Advisory Directors.

In addition to Cattleman's being owned in large part by the Moursund family, we are aware that other Directors of PEC at the time of its formation were approached about investing. At least two Directors appear to have made relatively small investments in the start-up of Cattleman's. It is not known whether Messrs. Fuelberg or Burnett, or any other members of PEC's Board, had an ownership interest in Cattleman's, or to what extent.

In addition to the Moursund ownership and control of Cattleman's, other PEC members also served on the Board of Cattleman's at various points in time. Mr. Fuelberg appears to have been an

[435] Federal Deposit Insurance Corporation, Individual Bank Information, Cattleman's National Bank.

Advisory Director on the Cattleman's Board since the bank was established, as was Mr. Melvin C. Winters, a Director with PEC from 1987 until his death in 1991. Mr. Val Smith served on the Board of Directors of Cattleman's from its formation until recently. In addition, Mr. R. B. Felps, PEC's current Board President, was serving on the Board of Directors at Cattleman's at the start of the investigation, and reportedly resigned in mid-2008, as did Mr. Val Smith.

PEC opened its first bank account at Cattleman's in 1987 and continued a banking relationship with Cattleman's through 2007. PEC maintained 12 of its 44 bank accounts at Cattleman's at the end of 2007 including "working funds" and "accounts receivable" accounts. "Working funds" accounts were used by PEC District offices or departments for their daily cash needs. These accounts typically maintained an average daily balance of less than $10,000. The "accounts receivable" accounts were used by the Districts or departments (e.g., cash management or call center) to deposit payments from members.

PEC did not pay a fee for the bank accounts with Cattleman's. However, Cattleman's was allowed a one (1) night float on any funds that were in the Cattleman's accounts. It is our understanding that PEC would "sweep" any funds each day in the Cattleman's "accounts receivable" accounts to the Cooperative's main JP Morgan Chase bank account. As a result, member payments would effectively remain in Cattleman's for no more than one day. It appears, based on analysis of the average daily balances in some of the accounts, as well as discussions with PEC personnel that the average daily balance in the Cattleman's account was approximately between $1.5 to $2.0 million. Depending on the applicable rate related to Cattleman's overnight deposits, the estimated benefit to Cattleman's resulting from the one-day float was approximately $45,000 – $60,000 per year.[436]

Rory Boatright, a Moursund-related consultant and employee, and who was listed for many years as the "Controller" of Texland, is also currently listed as a Director of Cattleman's. Cattleman's involvement with Texland is addressed in greater detail in another section of this Report.

10. Other Moursund-related entities

In addition to the entities discussed above, A.W. Moursund was affiliated with a number of other businesses during his lifetime, including but not limited to cattle, beverage, investment and drilling companies and a variety of other businesses for which the business purpose could not be determined. Our work involved searching the PEC general ledger and EDMS system for any payments or documents related to these other businesses. In addition, we reviewed the billing records for these entities to identify any preferential treatment that may have been received related to their electric service.

While a number of Moursund-related entities, including certain residences, had electric service from PEC, we did not identify any unusual rates structures, billing arrangements or customer credits that would lead us to believe that any of the Moursund-related entities received any additional benefit as a result of their affiliation with PEC.

[436] Calculated using an estimated average daily balance between $1.5 to $2.0 million and an interest rate of 3%.

In addition, we did not identify any additional payments to the Moursund-related entities through our research and analysis of PEC's general ledger and the EDMS document repository, other than what has been highlighted above.

C. Observations and Findings

A significant concern identified during the investigation was the relationship between PEC and the Moursund family and the potential conflicts of interest that likely existed with respect to the various services provided by the Moursund family to PEC, as well as the participation by several PEC Directors and management on the Board of Cattleman's bank. The potential for conflicts of interest, or perceptions of such conflicts, should have raised serious issues for the Board in its service of a Cooperative funded primarily by member contributions.

Both current and former members of the Board, as well as PEC managers, admitted knowing through personal knowledge that Cattleman's bank was owned by the Moursund family; that certain Directors sat on the Board of Cattleman's bank; and that Mr. Fuelberg had once sat on the Board of Cattleman's. It has also come to our attention that various current and former Directors, and potentially former management, had, and may still have limited ownership interests in Cattleman's bank. However, there was no systematic briefing of, or review and assessment by the Board of potential conflicts.

Judge Moursund had significant influence over the Cooperative for many years and that influence is evident in both the compensation he received and the fact that the PEC Board members and many others overlooked apparent conflicts of interests arising from the business relationships PEC engaged in with various Moursund-related entities at the same time Judge Moursund, and subsequently the Moursund Law Firm, served as PEC General Counsel. Judge Moursund was described as the driving force behind the Texland venture, which is discussed separately in this Report, as well as with respect to certain other strategic and operational ventures of the Cooperative. We were also told by various individuals that Judge Moursund essentially "ran the Cooperative" for many years.

It is relatively apparent that the Board exercised little control over the role Judge Moursund played at PEC. As with Messrs. Fuelberg and Burnett, no apparent mechanism existed to establish standards for gauging the appropriateness of the compensation Judge Moursund received, the business expenses incurred on his behalf, or the business relationships he fostered, including those that presented apparent conflicts of interest.

While relationships and opportunities for inappropriate influence are not uncommon in well-established privately-owned and controlled corporations, the benefits and detriments of loosely controlled operations in these circumstances are borne by the same owners who are responsible for decisions. In contrast, PEC is member-owned, and any improper influence on decision-making affected by conflict and self interest benefit the parties exercising that influence but create the potential for detriment to the Cooperative's members. While PEC has always been member-owned, it is evident that during the period under investigation the members had not had an apparent or at least active voice in its control for many years.

The Board has never instituted a conflicts of interest questionnaire or policy, which is considered one of the fundamental good governance practices for most Boards. In addition, the Board does not appear to have any process in place for monitoring and handling of potential conflicts that might arise.

1. Judge Moursund's Compensation was Approved by the Board

Judge Moursund's total compensation, including his monthly retainer and annual bonuses all appear to have been approved by the Board. During the investigation, we found no instances in which any of the various components of Judge Moursund's compensation had been agreed upon or instituted without the full knowledge of the Board. We also found no instances in which compensation initiatives benefiting Judge Moursund were presented to but rejected or diminished by the Board.

2. Questionable Conversion of Bonus to Retainer Payment in 2001

While we do not have an understanding as to why the Board, in 2001, converted Judge Moursund's bonus payments to an increase in his retainer, it is clear from the Board's actions that at some point in time, these payments became viewed as an entitlement rather than a merit-based reward, as had originally been conceived.

As with Messrs. Fuelberg and Burnett, the Board meeting minutes are vague and non-specific with regard to the bonuses approved for Judge Moursund during the mid to late 1990s and in 2000 and 2001, including often failing to describe the amount of the bonus payment being approved. While traditionally corporate Board minutes are often not reflective of the depth of discussions regarding a specific topic covered at a meeting, the consistency with which vague information appears in the PEC Board minutes in relation to bonuses for Judge Moursund, as well as those for Messrs. Fuelberg and Burnett, is noteworthy.

3. Basis for Judge Moursund's Compensation and Bonus Payments

Upon review of the historical policies and procedures for compensation of Judge Moursund, we identified only limited information used by the Board in support of its decisions. As previously stated, the Board did not task any separate committee (e.g., Compensation Committee) with the role of identifying, analyzing and evaluating the appropriate compensation for Judge Moursund. Furthermore, the Board's decisions do not appear to have been made with regard to any objective measures of performance, and opportunity for evaluation against those measures. The Board's decision-making with respect to Judge Moursund's compensation appears to have been perfunctory in nature.

As described, we also did not identify any rationale for the adjustment to covert the bonus payments received by Judge Moursund into an increase in his retainer. The adjustment appears to have been initiated by Mr. Fuelberg, rather than as the result of a Board-directed effort to adjust his compensation based on appropriate benchmarks, industry standards, or work performance.

4. No Formal Contracts/Agreements

No formal contract or agreement has been identified that outlined the scope of services or the responsibilities of Judge Moursund as the General Counsel. As such, there also does not appear to have been any measure upon which to gauge whether Judge Moursund's service to the Cooperative was deserving of the annual retainer and bonus amounts paid to him. In addition, there was no documentation that established the compensation or term of Judge Moursund's association with PEC. It appears that the Board would routinely approve the retention of Judge Moursund as General Counsel on an annual basis. The Board resolutions typically provided no detail as to the services to be provided and give only limited detail in relation his level of compensation (e.g., approval of the same monthly retainer as the previous year).

Formal documentation establishing the role of the Moursund Law Firm after Judge Moursund's death was only slightly more in evidence than for the period when he acted individually as General Counsel. The only description of the services provided by the Moursund-related entities was in the May 2002 Board resolution, as discussed above (i.e., "bad debt collection, real estate advice and closure, liability insurance procurement, and such other civil actions and tasks as may from time to time be authorized…").[437,438] However, no formal contract or agreement has been identified that outlined the scope of services, the term of service or the amount of compensation for the Moursund Law Firm.

5. Clark, Thomas & Winters and A.W. Moursund

Clark, Thomas & Winters ("Clark Thomas") also provided legal services and advice to PEC during the 1988 – 2007 time period. Clark Thomas' role relative to the Moursund Law Firm was also outlined in the May 2002 Board Resolution citing that Clark Thomas was being retained "as counsel for the Cooperative to represent it before regulatory agencies, administrative Boards and such other civil actions and tasks as may from time to time be authorized by Board Resolution or assigned by the General Manager."[439,440] We also have not identified a formal contract or agreement with Clark Thomas. Clark Thomas provided services to PEC primarily on a fee-for-service basis, and the firm's invoices typically included descriptions of the services performed.

Based on the electronic and hard copy information reviewed and discussions with PEC personnel, it appears that Clark Thomas essentially functioned as General Counsel for PEC. Clark Thomas was regularly consulted by PEC management on a number of matters including employment, regulatory and litigation related matters. It is unclear why PEC and the Board believed it was necessary to have two firms with the function of General Counsel, i.e., Clark Thomas and A.W. Moursund (and later the Moursund Law Firm) and to compensate them both at rates that appear commensurate with that role, but one through retainer and the other primarily through fee-for-service.

[437] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.
[438] This Board Resolution was reaffirmed by a September 19, 2005 Board Resolution.
[439] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.
[440] This Board Resolution was reaffirmed by a September 19, 2005 Board Resolution.

Clark Thomas' involvement with PEC is addressed in greater detail in a subsequent section of this Report.

6. Moursund's Debt Collection Efforts appear to have been Limited

One of the services provided by both Judge Moursund, and then the Moursund Law Firm, was in relation to PEC's delinquent customer accounts. It is our understanding that the Moursunds were responsible for collection efforts in relation to the PEC customer accounts to be written off each month. A routine procedure at each month's Board meeting would be the approval of certain customer accounts to be written off. A list would be included in the Board package each month that contained the delinquent customer accounts for approval by the Board. That list would subsequently be provided to the Moursund Law Firm.

Based on our understanding of the process, upon receipt of the list, the Moursund Law Firm would send a letter to each customer/member and in certain instances, when the outstanding balance exceeded a pre-set limit, make individual telephone calls. The Moursund Law Firm was also responsible for collecting payments from the customer and forwarding the payments on to PEC. The letters and limited phone calls, however, appear to have been the extent of the Moursund Law Firm's efforts in this regard. It was our understanding that PEC seldom, if ever, initiated legal proceedings or otherwise escalated its efforts at collection beyond the initial letters.

The debt collection service is one of the few described services in relation to the $16,772 per month retainer received by the Moursund Law Firm. While Judge Moursund, as well as representatives from the Moursund Law Firm (primarily Will Moursund) in later years routinely attended PEC Board meetings, they were also compensated at $1,200 per meeting for the Board secretarial duties. In addition, it is more common in current practice for outside collection agencies to be compensated on the basis of their collections, rather than on a flat fee/retainer basis.

In evaluating PEC's collections process, we attempted to evaluate the amount of collections processed through the Moursund Law Firm relative to the total amount of accounts written off each year. However, there was limited documentation in PEC's possession related to the Moursund Law Firm's efforts to collect on the delinquent consumer accounts. In reality, while PEC tracked the list of accounts to be written off each month that was subsequently provided to the Moursund Law Firm, PEC does not track, in any reliable measure, the collections against those accounts. While acknowledging that certain checks or payments are periodically forwarded from the Moursund Law Firm, PEC did not typically maintain any records of those receipts.

In addition, absent tracking the collections received through the Moursund Law Firm's efforts, PEC had no means of evaluating the effectiveness of the Moursund Law Firm's efforts in this regard, nor any controls in place to determine if the payments received by the Moursund Law Firm were properly forwarded to PEC. While we have noted no evidence that any collections were misappropriated in this manner, there is a notable lack of documentation surrounding the overall collection efforts.

PEC's bad debt expense over the past five years has been significant. In comparison to other cooperatives in the United States and Texas, including large cooperatives, PEC's uncollectible accounts each year as a percent of its operating revenue are significantly higher. Differences exist between various cooperatives based on their respective regions and the demographics of their members, but the fact that PEC has a significantly higher level of bad debt expenses appears to be reflective of the ineffectiveness of PEC's, and the Moursund Law Firm's, collection efforts. While PEC's outstanding accounts receivable (over 60 days) appear more in line with the median level for the cooperatives surveyed, PEC's ultimate write-off of delinquent accounts is substantially higher. A comparison of PEC's accounts receivable (over 60 days) and uncollectible accounts as a percent of operating revenue to other cooperatives is summarized in the table below:

Summary of Select Key Ratios as a % of Operating Revenue					
A/R Over 60 Days	**2002**	**2003**	**2004**	**2005**	**2006**
PEC	***0.22***	***0.18***	***0.18***	***0.21***	***0.24***
Large Co-ops Median	0.33	0.29	0.28	0.31	0.23
U.S. Co-ops Median	0.25	0.23	0.22	0.23	0.20
Texas Co-ops Median	0.25	0.24	0.24	0.20	0.20
Amount Written Off During the Year					
PEC	***0.30***	***0.47***	***0.40***	***0.43***	***0.46***
Large Co-ops Median	0.30	0.29	0.25	0.24	0.25
U.S. Co-ops Median	0.21	0.21	0.20	0.18	0.18
Texas Co-ops Median	0.25	0.21	0.20	0.17	0.19
PEC - Amount Written Off	$ 843,166	$ 1,445,907	$ 1,479,723	$ 1,760,439	$ 2,277,463

Source: Cooperative Finance Corporation (CFC) Key Trend Ratio Analysis and CFC Form 7, Part K, line 2.

As an example evidenced from the above table, if PEC's write-offs had been more in line with the median for Large Co-ops displayed above, PEC would have saved over $1 million last year.

We were told that Mr. Fuelberg was unwilling to aggressively pursue collection out of fear for PEC's reputation with the Cooperative's members. However, we were also told that PEC had the reputation for not collecting, thereby providing incentive to members inclined to default.

Based on a preliminary analysis of the debt collection process in 2007, the Moursund Law Firm was provided written-off accounts from PEC totaling in excess of $2.4 million during the January 1, 2007 to December 31, 2007 time period. Of these accounts, approximately $246,766 appear to have been collected between January 1, 2007 and June 30, 2008.[441] While collection processes typically take place over long-term periods as the debts begin to season, the Moursund Law Firm's collection efforts appear to have been primarily limited to a letter to each account sometime within the first two months of the account's delinquency. Thus, the collected amount referenced above is likely a reasonably large proportion of the ultimate accounts to be collected on the 2007 portfolio of written-

[441] Includes $222,939 in payments made directly to Pedernales Electric Cooperative, Inc. and $23,827 in payments made to the Moursund Law Firm subsequently forwarded to Pedernales Electric Cooperative, Inc.

off accounts. While the $246,766 represents all collections, including collections paid directly to PEC (i.e., whether related to the efforts of the Moursund Law Firm or not), by comparison the Moursund Law Firm's annual retainer in 2007 of $201,264 was not significantly below this, raising the question as to the cost/benefit relationship for this service, especially in light of PEC's poor debt collection ratio compared to those of other cooperatives.

Pursuant to the Moursund Law Firm's termination in August 2008, the collection efforts were taken in-house by PEC which is currently working on developing more proactive and staged collection process.

7. No Board Secretarial Services Provided

As described, Judge Moursund and later the Moursund Law Firm received a monthly payment of $1,200 ($14,400 annually) to "furnish secretarial services for the Board of Directors of the Cooperative" beginning in July 1991.[442] Based on electronic and hard copy documentation we reviewed and interviews we conducted with PEC personnel, we have determined that neither Judge Moursund nor the Moursund Law Firm appear to have provided any services as Board Secretary to the PEC Board during the 1998 – 2007 time period. Despite the Moursunds being paid the monthly secretarial Board fee, it is our understanding that the assistants in the General Manager Department took notes and actually prepared the minutes of each Board meeting.

8. Sole Source Arrangement with the Moursund Insurance Agency

The Moursund Insurance Agency has provided insurance services as a broker since approximately 1979. For at least the last 10 years, the Moursund Insurance Agency has functioned as PEC's sole insurance agent serving as the broker or co-broker for all of the Cooperative's insurance policies.[443] As a result, PEC did not solicit information or policy premium bids from other insurance agents. While the Moursund Insurance Agency would present several policy options to PEC for each insurance policy, the evaluation and selection process did not allow for PEC to compare to other options the total premium cost inclusive of the commission paid to the Moursund Insurance Agency.

The Moursund Insurance Agency is currently compensated on a commission basis under which it receives a percentage of each insurance policy premium. State laws do not require commission rates to be disclosed to companies by insurance agents. As a result, it is difficult to compare the commission rates charged by the Moursund Insurance Agency to rates charged by other agents.

However, upon request by PEC, the Moursund Insurance Agency provided the commission rates charged to PEC on each of its policies in March 2008. The Moursund Insurance Agency also committed to "make it a practice to disclose to PEC the commission on all future policies."[444] Through the current year, the Moursund Insurance Agency is continuing to provide services to PEC

[442] Pedernales Electric Cooperative, Inc. Board Resolution, June 15, 1991.
[443] Letter from Jay Frasier to Kimberly Paffe Re: Disclosure of Commission Rates, March 14, 2008.
[444] The Moursund Insurance Agency Co-Brokers several policies with Carol Griffin from Powell & Meadows and one policy with Blais Excess & Surplus Agency of Texas.

on its existing insurance policies. However, it is PEC's intent to open the process to competition as the various insurance policies come up for renewal throughout the coming year.

9. Potential Conflicts of Interest with Cattleman's National Bank

With respect to Cattleman's bank, the Moursund family's ownership interest in Cattleman's, as well as the Board positions and potential ownership interests by Mr. Fuelberg and various PEC Directors, raises significant questions about the potential for impropriety. These dual roles by key decision-makers at PEC placed a number of PEC employees and PEC-affiliated individuals into positions in which significant potential conflicts of interest may have existed during the period under investigation.

PEC, as is common for many cooperatives, makes an effort to patronize local businesses in its service area, and therefore maintains multiple bank accounts across the service area. This beneficial practice should not, however, obscure the need for PEC and its Board to carefully monitor service provider transactions for potential conflicts of interest.

The long-standing relationship between PEC, the Moursund family and Cattleman's (since 1986), as well as the support of Messrs. Fuelberg and Burnett, and the apparent openness of the Moursunds' ownership interest in Cattleman's, may have minimized the Board's perception of any impropriety. However, as with other areas, we find no evidence that the Board evaluated whether PEC's business arrangement with Cattleman's was beneficial and optimal to PEC, whether there were potential conflicts with PEC Board members who were also serving on Cattleman's Board, or how the relationship might be perceived by the Cooperative's members, and others.

As with any potential conflict of interest, the potential that parties or entities could be placed in a position of conflict where one must choose between two competing interests is as important as whether the parties have actually found themselves in that position over time.

All but one of the Cattleman's accounts were moved to other institutions in August 2008 subsequent to the discovery of the Texland bank account. The remaining account is scheduled to be moved on January 15, 2009.

10. Evaluation of Services Provided

Judge Moursund clearly had a significant role in PEC operations during his long history with PEC, and with respect to the Texland project. However, little information was identified from the hard-copy and electronic information we reviewed as to Judge Moursund's exact role and responsibilities with the Cooperative on a day-to-day basis. We did not identify any contracts or agreements that outlined Judge Moursund's primary tasks and services provided as General Counsel, other than periodic Board resolutions authorizing the release of the Cooperative's uncollectible consumer accounts to Judge Moursund for collection.

During the period they were compensated on retainer, neither Judge Moursund nor the Moursund Law Firm provided any sort of invoice or description of the services they performed on behalf of the

Cooperative. Consistent with this lack of documentation, we have identified only limited justification for PEC's continued affiliation with Judge Moursund and the Moursund Law Firm at the compensation levels they received. The services provided by Judge Moursund and the Moursund Law Firm in consideration for their retainer appear to have been (i) attendance at PEC board meetings; (ii) the debt collection services; and (iii) any general consultation, although we identified no documentation supporting the existence of such consultation. Based on our discussions with PEC personnel, we found a general perception that Judge Moursund and the Moursund Law Firm as General Counsel provided PEC with limited value in proportion to their compensation during the investigation period.

The primary basis for PEC's continued affiliation with Judge Moursund and the Moursund Law Firm thus appears to have been one of preference by Mr. Fuelberg, based on a long-standing tradition.

PEC terminated its existing relationships with the Moursund family through the Moursund Law Firm in August 2008.[445] It is our understanding that it is PEC's intent to open the insurance procurement process up to competition as the various insurance policies come up for renewal throughout the coming year and that it has moved all but one of its bank accounts from Cattleman's bank.

D. Recommendations

Moursund Relationship

- As cited above, PEC took steps to sever its long-standing ties and relationships to the Moursund family and its related business interests in 2008. PEC's efforts included terminating the Moursund Law Firm as General Counsel and their monthly retainer of $16,772, terminating the Moursund Law Firm's responsibility in relation to Board secretarial duties as well as the associated $1,200 per month payment, and closing and removing PEC's funds from all but one of its bank accounts held at Cattleman's. In addition, the debt collection services function was taken in-house by PEC, and PEC plans to solicit new bids for brokerage services, as well as insurance contracts, that come up for renewal in the upcoming year. Navigant Consulting considers the changes as summarized above to be appropriate.

Conflicts of Interest

- The apparent and perceived conflicts of interest in relation to the Moursund-related entities arose over a long-period of time in relation to long-standing ties and history between PEC and Judge Moursund. While it is not inconceivable that such a relationship could once again have a significant influence on the operations of the Cooperative, as well as the Board, the circumstances giving rise to the current situation are unlikely to be repeated. The longevity of the Moursund relationship appears due, in part, to the weakened and ineffective oversight by the Board, as well as to the strong continued support by the former PEC General Manager. However, the absence of clear guidance provided through an effective conflict of interest questionnaire and policy, as well as procedures to address apparent conflicts, gave the Board no justification to address these issues. Navigant Consulting has made various

[445] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., August 18, 2008.

recommendations with regard to Board policies and procedures to provide additional guidance in relation to conflicts of interest in other sections of this Report. Those recommendations are incorporated by reference.

XX. Charitable Organizations

A. Background

In addition to Envision and the former Texas Skies subsidiary, the Cooperative supported two charitable organizations during the period under investigation; PEC United Charities, Inc. ("United Charities") and the PEC Scholarship Fund ("Scholarship Fund").

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and evaluating the charitable organizations associated with the Cooperative during the period 1998 – 2007. Our efforts consisted of reviewing and evaluating information related to these entities and conducting interviews with former and current Cooperative personnel regarding the activities of these entities.

More specifically, the scope of our work included the following:

- Requesting and reviewing information related to United Charities and the Scholarship Fund, including organizational information (bylaws), meeting minutes, and financial information (e.g., financial statements and Form 990s).

- Identifying and evaluating the sources and uses of funds for United Charities and the Scholarship Fund, including a review of organizations that received disbursements or payments from these charitable entities.

- Preparing a schedule summarizing the sources and uses of funds for United Charities and the Scholarship Fund.

- Conducting interviews and discussions with Cooperative personnel regarding United Charities and the Scholarship Fund.

2. Background

PEC United Charities, Inc.

United Charities was created by PEC in or around 1988. The stated purpose of United Charities is to provide the employees of the Cooperative "with a method of collectively supporting, through monetary contributions, charitable causes, general welfare efforts, community improvement projects, and such other activities of a charitable nature…"[446] Its membership consists of employees of the Cooperative who make monthly contributions to United Charities through payroll deductions.[447] It is

[446] United Charities Bylaws, approved on April 25, 2003.
[447] United Charities Bylaws, approved on April 25, 2003.

our understanding that a high percentage of PEC employees participate in the United Charities program and that the standard deduction was established as 70% of one hour's pay from a participating employee's payroll check for the first pay period of the month.[448]

During the period under investigation, the employees' monthly contributions were matched by the Cooperative through a Board-approved payment from the general operating fund of the Cooperative. The matching payment was booked to the administrative and general expense account, GL Acct. 954 – Other Deducts – Donations. The yearly matching contribution ranged from a low of $57,308 in 1998 to $249,721 in 2006 and averaged $111,600 during the period 1998 – 2007. The Cooperative's matching contribution in 2006 was more than double that of any other year, as a result of a December Board resolution authorizing "that the Cooperative's match to the employee contributions for the 2006 United Charities Fund be doubled," a directive that resulted in an additional $125,000 being donated to United Charities.[449,450]

At the end of each year, total contributions are allocated equally to all participating employees. Employees select one or more beneficiaries from a pre-determined list of beneficiaries to receive a portion of their allocation. The beneficiaries consist of community-oriented organizations including libraries, fire departments, chambers of commerce, hospitals, churches, and other charitable organizations.

A summary of the contributions and disbursements for United Charities is summarized below.

Summary of PEC United Charities Activity for 1998-2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Summary
Beginning Balance	**$ 233**	**$ 4**	**$ 52**	**$ 864**	**$ 2,701**	**$ 570**	**$ 1,297**	**$ 6,134**	**$ 10,329**	**$ 5,843**	**$ 233**
Contributions											
Employee Deductions	57,308	65,370	76,733	90,250	98,949	106,403	113,220	119,596	124,721	138,441	990,989
Board Match	57,308	65,370	76,733	90,250	98,949	106,403	113,220	119,603	249,721	138,441	1,115,997
Interest	3,449	3,631	4,062	3,169	2,007	2,182	2,508	4,241	6,218	9,867	41,334
Adjustments	-	-	-	72	-	1,525	-	165	1,694	598	4,053
Misc. Employee Donations	-	-	-	2,900	50	1,560	-	-	107	-	4,617
Total Contributions	$118,066	$134,371	$157,527	$186,641	$199,954	$218,072	$228,947	$243,605	$382,460	$287,347	$2,156,990
Disbursements	(118,295)	(134,322)	(156,715)	(184,805)	(202,085)	(217,345)	(224,110)	(239,410)	(386,945)	(289,290)	(2,153,323)
Ending Balance	**$ 4**	**$ 52**	**$ 864**	**$ 2,701**	**$ 570**	**$ 1,297**	**$ 6,134**	**$ 10,329**	**$ 5,843**	**$ 3,900**	**$ 3,900**

The PEC Golf tournament, sponsored by PEC on behalf of United Charities, began in or around 2003.[451] It is our understanding that all proceeds from the golf tournament are donated to United Charities.

[448] United Charities Bylaws, approved on April 25, 2003.

[449] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 11, 2006.

[450] The matching contribution by the Board for the period 1998 – 2005 and 2007 was a one-for-one match to the employee contributions.

[451] Letter from Joan White to Jimmy Leinneweber, June 24, 2003.

PEC Scholarship Fund

The Scholarship Fund was created in approximately 1999 and was established for the purpose of redirecting unclaimed property funds controlled by PEC into scholarships for rural students as permitted by the Texas Property Code.[452,453] It appears that the Board also made additional contributions to the Scholarship Fund. In addition, it appears that contributions were made through United Charities to the Scholarship Fund. The scholarships are awarded to selected graduating seniors and may be applied toward tuition, fees, and expenses at any college, university, junior college, technical school, or trade school.[454] The scholarship recipients are chosen by judges, who are selected by the PEC Scholarship Committee, based on information provided on the application for scholarship, prior academic performance, standardized test results, motivation, character and financial need.[455]

The Scholarship Fund received average yearly contributions of over $25,000 totaling in excess of $230,000 during the period 1999 – 2007. The total contributions increased significantly in the period 2005 – 2007 as a result of contributions from PEC that were authorized by the Board. Over 65% of the total contributions were from PEC. In 2000, 2002, and continuing from 2004 through 2007, the Board would typically authorize a lump-sum donation from PEC each year in May/June and October. It appears that the May/June donation was used to provide funds sufficient for the determined number of scholarships to be awarded in that particular year. A March 2005 Board resolution increased the number of $1,000 scholarships to be awarded from 25 to 50.[456] The October lump-sum donation appears to be related to the Board's authorization of the donation of PEC's Escheat Funds (unclaimed funds) to the Scholarship Fund.[457] The majority of the remaining funds were contributed by United Charities and other donations from employees. The individual scholarships awarded averaged $1,000.

A summary of the contributions and disbursements for the Scholarship Fund is included below.

[452] Descriptions for IRS Form 1023, Part II, #5.
[453] Letter from Joe Martin, Finance manager to Ms. Kay Tuggle, office of the Comptroller of Public Accounts, October 2, 2000.
[454] Pedernales Electric Cooperative, Inc. Scholarship Fund information from the Pedernales Electric Cooperative, Inc. website.
[455] Pedernales Electric Cooperative, Inc. Scholarship Fund information from the Pedernales Electric Cooperative, Inc. website.
[456] Board Resolutions Pedernales Electric Cooperative, Inc., March 14, 2005.
[457] It appears that the Board made an additional donation matching the Escheat Funds in December 2000.

Summary of PEC Scholarship Fund Account Activity for 1999 - 2007	1999	2000	2001	2002	2003	2004	2005	2006	2007	Summary
Beginning Balance	**$ 2,533**	**$ 4,466**	**$ 15,811**	**$ 12,724**	**$ 26,035**	**$ 9,603**	**$ 11,662**	**$ 10,601**	**$ 17,261**	**$ 2,533**
Contributions										
Board	$ -	$ 8,337	$ -	$ 15,339	$ -	$ 16,000	$ 40,000	$ 42,000	$ 38,000	$ 159,677
Escheat Funds	1,856	3,337	3,211	3,431	1,186	5,423	4,210	4,179	3,307	30,139
United Charities	-	3,376	3,135	2,700	3,235	4,135	2,825	3,152	4,158	26,716
Other	-	563	2,075	4,240	3,970	1,429	2,010	140	370	14,797
Interest Income	77	256	406	216	179	131	245	232	176	1,917
Total Contributions	**$ 1,933**	**$ 15,870**	**$ 8,827**	**$ 25,926**	**$ 8,570**	**$ 27,118**	**$ 49,290**	**$ 49,703**	**$ 46,010**	**$ 233,246**
Disbursements										
Miscellaneous	$ -	$ (25)	$ (414)	$ (115)	$ (2)	$ (59)	$ (351)	$ (42)	$ (85)	$ (1,092)
Scholarships	-	(4,500)	(11,500)	(12,500)	(25,000)	(25,000)	(50,000)	(43,000)	(53,000)	(224,500)
Total Disbursements	**$ -**	**$ (4,525)**	**$ (11,914)**	**$ (12,615)**	**$ (25,002)**	**$ (25,059)**	**$ (50,351)**	**$ (43,042)**	**$ (53,085)**	**$ (225,592)**
Ending Balance	**$ 4,466**	**$ 15,811**	**$ 12,724**	**$ 26,035**	**$ 9,603**	**$ 11,662**	**$ 10,601**	**$ 17,261**	**$ 10,187**	**$ 10,187**

C. Observations and Findings

1. Disbursements from the Scholarship Fund and United Charities

As described, funds from United Charities and the Scholarship Fund were disbursed to students and a variety of community-related organizations. Based on the review of available hard-copy and electronic information and on discussions with Cooperative personnel, we were able to trace the contributions into and disbursements out of the Cooperative's charitable organizations. Based on the analysis, we did not identify any disbursements from United Charities or the PEC Scholarship Fund to related, affiliated, or otherwise inappropriate parties.

In June 2003, PEC Finance Department personnel completed a "Review of United Charities Accounting for 2002."[458] The review included the following worksteps.[459]

- Reviewing accounting records (i.e., spreadsheets, bank statements).
- Reviewing Articles of Incorporation and Bylaws for changes or items of non-Compliance.
- Requesting negative confirmations from the recipient charities.
- Testing employee ballots (which were used for designating beneficiaries).

The results of the review "disclosed very few matters that might merit discussion."[460]

2. Cooperative Matching Donation to United Charities

As described, by means of a Board resolution, the Cooperative matched the monthly United Charities contributions by PEC employees. The Board authorized the Cooperative to donate over $1.1 million

[458] United Charities Bylaws approved on April 25, 2003.

[459] Letter Leinneweber from Joan White, Re: Review of United Charities Accounting Procedures to Jimmy and attached "Agreed Upon" Review Procedures, May 29, 2003.

[460] Letter from Joan White to Jimmy Leinneweber, Re: Review of United Charities Accounting for 2002, June 24, 2003.

to United Charities during the period 1998 – 2007 through the matching contributions. The amount donated to United Charities each year effectively comes out of PEC's net margin, thereby decreasing the amount of patronage capital allocated to the members each year.

3. Cooperative Matching Donation was Doubled in 2006

The Board authorized the Cooperative to double the 2006 matching contribution to United Charities in December 2006. As a result, the yearly contribution was increased from approximately $125,000 to $250,000. PEC experienced record margins in 2006 of over $60 million. While the Board's increase of the United Charities contribution in 2006 may be unrelated, we understand that PEC attempted to identify additional expenses at year-end in 2006 to offset the significant margins incurred.

4. Informal Policy of Mandatory Employee Participation in United Charities

As described, a high percentage of PEC employees participated in United Charities. However, we understand that that PEC employees were strongly encouraged, if not pressured, to participate by the former General Manager. It is our understanding that Department and District managers were instructed to strongly encourage employee participation in United Charities and to report their employees' participation in United Charities to the former General Manager. In addition, it appears that a lack of participation in United Charities could affect an employee's evaluations and that there was at least one instance in which an employee bonus appears to have been questioned by the former General Manager because the employee in question had not contributed to United Charities.

D. Recommendations

Evaluate Board Matching Contributions to United Charities

- As described, the Board matches the monthly employee contributions to United Charities, and on at least one occasion, doubled the matching contribution for the full year. While charitable programs should be commended, it is recommended that PEC establish a clearly-defined plan and policy regarding the determination of the appropriate matching contributions for the Cooperative to make each year relating to the United Charities program.

Establish Formal Policy and Procedure for Employee Participation

- The Cooperative's informal policy for encouraging employee contributions in United Charities might be construed as overly aggressive. It is recommended that PEC evaluate its existing policy and procedure related to employee participation in United Charities to ensure that it is consistent with applicable laws and regulations and that the policy clearly outlines the conditions regarding participation by employees in United Charities.

XXI. Other Related Parties and Affiliated Entities

A. Background

Throughout the course of the class action lawsuit, as well as during the investigation, questions were raised regarding relationships between PEC and certain known affiliated or related entities including Texland Electric Cooperative, Inc., Texas Skies, Inc. and Envision Utility Software Corporation, as well as the Moursund Law Firm and Cattleman's National Bank. In light of the questions raised regarding these parties, we identified and evaluated other PEC related or affiliated entities.

B. Work Performed

1. Scope of Work

Included in the scope of Navigant Consulting's work was the identification and investigation into any related entities of PEC and the evaluation of the historical relationship between PEC and those entities, including the purpose of the entities and why certain entities remained in existence. Initial efforts were focused on identifying information in PEC's possession associated with the related entities including a search of PEC's electronic data management system ("EDMS"), a detailed search for historical accounting information, and discussions with various PEC employees. Our investigation focused on the following related entities, covering the period 1998 – 2007:[461]

- Pedernales Water Supply and Sewer Service Corporation
- PEC REP, Inc.
- LCRA REP, Inc.
- Association of Large Distribution Cooperatives
- Wholesale Power Alliance
- Texas VI Satellite, Inc.

More specifically, the scope of our work included the following:

- Performing detailed searches through publicly available information including searches of public filings with the Texas Secretary of State to identify entities potentially related to PEC, as well as information related to those entities.

- Performing detailed searches through the general ledger to identify, categorize and quantify any payments to the related entities.

- Identifying Board minutes and/or resolutions related to the identified related entities.

[461] Results from our investigation related to Envision Utility Software Corporation, Texas Skies, Inc., United Charities, Inc., Scholarship Fund, Texland Electric Cooperative, Inc., and Texland Electric Company are included in other sections of this Report.

- Reviewing and analyzing electronic and hard-copy files and information retained by PEC including searches of PEC's EDMS database for relevant information.

- Conducting interviews and discussions with current and former Cooperative personnel regarding the related entities.

2. Limitations on Work Performed

Given the ten-year scope of the investigation (1998 – 2007) and that certain of the related entities were no longer utilized by the Cooperative and in some instances appear never to have been used, certain information was not available or reasonably accessible. Because of employee departures, as well as PEC former management's propensity to rotate employees among various positions, we also did not always find direct institutional knowledge with regard to the creation, purpose and management of certain of the related entities. Little appears to have been known by either the PEC staff or Board members about the origination or purpose of some of the related entities discussed below; thus it appears that only Mr. Fuelberg may have had information about the creation and purpose of these entities.

3. Background

<u>*Pedernales Water Supply and Sewer Service Corporation*</u>

An April 1987 Board resolution authorized General Counsel A.W. Moursund to "set up a proposed water and sewer service corporation for the Board to study to determine if this is the kind of corporation needed by this Cooperative."[462] The Pedernales Water Supply and Sewer Service Corporation was incorporated by Bennie Fuelberg, W.W. Burnett and Hilda Kroll on behalf of PEC on June 16, 1987 as a domestic nonprofit corporation in Texas. Mr. Fuelberg was listed as the President, Mr. Burnett as the Vice President and Ms. Kroll was listed as Secretary and Treasurer.[463] The purpose of organization for the entity was listed as:

> *"The purpose of furnishing a water supply of sewer service, or both, to towns, cities, counties, other political subdivision, private corporations, individuals, and military camps and bases, and for the purpose of providing a flood control and drainage system for towns, cities, counties, other political subdivisions, private corporations, individuals or other person."*[464]

PEC personnel filled out the Texas Franchise Tax Public Information Report form each year and the Finance Manager signed the form each year as the "officer, Director or other authorized person." An exception was 2006 when Mr. Fuelberg signed the form. The Pedernales Water Supply and Sewer Service Corporation was dissolved by PEC on July 6, 2007.[465] Based on the review of hard copy and electronic information and discussions with current Cooperative personnel, it is our understanding

[462] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 20, 1987.
[463] Pedernales Water Supply and Sewer Service Corporation Secretary of State Website information.
[464] Articles of Incorporation Pedernales Water Supply and Sewer Service Corporation, May 18, 1987.
[465] Pedernales Water Supply and Sewer Service Corporation Secretary of State Website information.

that the Pedernales Water Supply and Sewer Service Corporation was not utilized by PEC at any time. We have identified no payment to, or involving the Pedernales Water Supply and Sewer Service Corporation nor any evidence of a separate bank account utilized by or for that entity.

PEC REP, Inc.

PEC REP, Inc. ("PEC REP") was incorporated by Bennie Fuelberg on behalf of PEC on March 26, 2001 as a domestic for-profit corporation in Texas. W.W. Burnett was listed as the President, E.B. Price as the Vice President and O.C. Harmon was listed as Secretary and Treasurer. The purpose of organization for the entity was listed as:[466]

> *"The purpose for which the corporation is organized is the transaction of any and all lawful business for which corporations may be organized under the Texas Business Corporation Act."*

PEC personnel filled out the Texas Franchise Tax Public Information Report form each year and the Finance manager signed the form each year as the "officer, Director or other authorized person." Again, in 2006, Mr. Fuelberg signed the form.[467,468,469] Unlike investor-owned utilities in Texas, PEC, like other cooperatives and municipally-owned utilities, was not required to open its service area to competition on December 31, 2001, but had the option of doing so.[470] However, PEC was "preparing to compete in the electric market place" in 2001 and created two retail electric providers (i.e., REP) entities, including PEC REP and LCRA REP, Inc. to allow its members to purchase LCRA-generated electricity.[471] PEC ultimately decided not to open its service area to competition. Based on the review of hard copy and electronic information and discussions with current Cooperative personnel it is our understanding that PEC REP was not utilized by PEC after its incorporation. We have identified no payment to, or involving PEC REP nor any evidence of a separate bank account. PEC REP was dissolved on November 12, 2008.[472]

LCRA REP, Inc.

LCRA REP, Inc. ("LCRA REP") was incorporated by Bennie Fuelberg on behalf of PEC on March 26, 2001 as a domestic for-profit corporation in Texas. W.W. Burnett was listed as the President, E.B. Price as the Vice President and O.C. Harmon was listed as Secretary and Treasurer. The purpose of organization for the entity was listed as:[473]

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466 Articles of Incorporation of PEC REP, Inc., March 26, 2001.
467 Articles of Incorporation of PEC REP, Inc., March 26, 2001.
468 PEC REP, Inc., Secretary of State Website information.
469 PEC REP, Inc., Unanimous Written Consent of Directors in Lieu of Organizational Meeting.
470 Pedernales Electric Cooperative, Inc. Annual Report 2001.
471 Pedernales Electric Cooperative, Inc. Annual Report 2001.
472 PEC REP, Inc., Secretary of State Website information.
473 Articles of Incorporation of LCRA REP, Inc., March 26, 2001.

"The purpose for which the corporation is organized is the transaction of any and all lawful business for which corporations may be organized under the Texas Business Corporation Act."

PEC personnel filled out the Texas Franchise Tax Public Information Report form each year and the Finance manager signed the form each year as the "officer, Director or other authorized person" except for 2006 when Mr. Fuelberg signed the form.[474,475,476] As with PEC REP, LCRA REP was created when PEC was "preparing to compete in the electric market place."[477] Based on the review of hard copy and electronic information and discussions with current Cooperative personnel it is our understanding that LCRA REP was not utilized by PEC after its incorporation. We have identified no payment to or involving LCRA REP nor any evidence of a separate bank account. LCRA REP was dissolved on November 12, 2008.[478]

Association of Large Distribution Cooperatives

The Association of Large Distribution Cooperatives ("ALDC") was incorporated by Bennie Fuelberg on August 23, 2001 as a domestic nonprofit corporation in Texas. The ALDC was a group of approximately twelve larger distribution cooperatives that formed an association focused on the specific needs of larger cooperatives (the average member cooperative in the NRECA was significantly smaller). Bennie Fuelberg and seven other individuals from other large electric cooperatives in the United States were listed as the Directors. Bennie Fuelberg was listed as the President, Cecil Viverette, Jr. (Rappahannock Electric Cooperative) as the Secretary and Richard Newland (Connexus Energy) was listed as Treasurer.[479] The purposes of organization for the entity were listed as: [480]

"(a) To improve the business conditions of large electric cooperatives in the electric utility industry;

(b) To provide a forum for the discussion and research of issues affecting the electric utility industry particularly related to the role of electric cooperatives in that industry;

(c) To foster the interests of large electric cooperatives in the electric utility industry;

(d) To enhance the contribution of such businesses to the electric utility industry in the United States through research and educational activities; and

474 Articles of Incorporation of LCRA REP, Inc., March 26, 2001.
475 LCRA REP, Inc. Secretary of State Website information.
476 LCRA REP, Inc. Unanimous Written Consent of Directors in Lieu of Organizational Meeting.
477 Pedernales Electric Cooperative, Inc. Annual Report 2001.
478 LCRA REP, Inc. Secretary of State Website information.
479 Articles of Incorporation of Association of Large Distribution Cooperatives dated August 6, 2001.
480 Articles of Incorporation of Association of Large Distribution Cooperatives, August 6, 2001.

> *(e) To facilitate the sound operation of the business of its members by providing programs and resources for employee benefits, training, regulatory compliance, and other matters of common concern to its members."*

The PEC Board was informed of the ALDC in June 2001. Board meeting minutes state:[481]

> *"Meeting of Large Electric Cooperatives group held recently in San Antonio. Discussed problems with NRECA, and a desire to form a new organization… Plans are to meet again later this month in Chicago to determine the interest in forming a new association for large electric cooperatives."*

We identified two $5,000 payments to the ALDC during the period August 2001 – 2007. PEC paid ALDC membership dues in 2003 and 2004. The ALDC has not been dissolved and remains an active corporation. However, it is our understanding that PEC no longer participates as an active member of the ALDC.

We have also identified expenses incurred by the Directors and former Senior Management related to the ALDC. Director and Senior Management expenses are discussed in detail in previous sections of this Report. However, we did identify at least one 2003 ALDC meeting for which the overall cost of essentially a nine-hour trip for the former General Manager and his wife, Directors and their spouses, as well as PEC's outside Counsel Walter Demond (Clark, Thomas) and David Sibley, a long-time lobbyist for the Cooperative, appears to have been over $58,000.[482]

PEC decided to terminate its relationship with the ALDC in November 2004. A letter from Mr. Fuelberg stated: [483]

> *"…the Board of Directors of Pedernales Electric Cooperative had discussed the ALDC meetings and decided the current direction the group was pursuing was not one which met PEC's needs… our desire was to have a forum for similar systems to exchange information and ideas about policies and operations which could benefit our members. We also wanted to establish a presence in Washington which would enable us as a group to influence legislation which could impact us, but might be different from NRECA's needs."*

Wholesale Power Alliance

The Wholesale Power Alliance ("WPA") was organized in or around March 2006 by a group of wholesale electric customers of the Lower Colorado River Authority ("LCRA") to negotiate a new wholesale power agreement.[484] Neither PEC nor any individuals associated with PEC were involved in incorporating or organizing the WPA and PEC was not a member of the WPA. However, PEC did

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481 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., June 16, 2001.
482 The expenses associated with the 2003 ALDC meeting are discussed in greater detail in a previous section of the Report.
483 Letter from Bennie Fuelberg, General Manager to Mr. Richard Newland, President & CEO of Connexus Energy, November 30, 2004.
484 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 20, 2006 .

support the WPA financially. PEC made payments totaling $150,000 in 2006 and $100,000 in 2007 to Guadalupe Valley Electric Cooperative that were booked to *GL Acct. # 954 – Other Deductions – Donations* relating to the Wholesale Power Alliance. A cover letter for one of the payments stated:[485]

> *"Enclosed is a check payable to GVEC to be used by the Wholesale Power Alliance to further its efforts in finding alternatives to LCRA power. While Pedernales Electric Cooperative is not joining the Alliance, we do support the other customers' quest for a less 'Authoritarian' power supply and will keep you informed of our efforts when possible."*

The 2006 payments were approved by Board resolutions that stated, "the Cooperative will make a donation in the amount of $50,000 to the Wholesale Power Alliance group" and "General Manager Fuelberg is authorized to contribute up to $100,000 to the Wholesale Power Alliance."[486] We have not identified a Board resolution or minutes related to the $100,000 payment in 2007.

We have been unable to determine with specificity the reason that PEC was not a member of the WPA and why these payments were made indirectly to the Wholesale Power Alliance through GVEC.

Texas VI Satellite, Inc.

Texas VI Satellite, Inc. ("Texas VI Satellite") was incorporated by Robert Loth, III on December 22, 1987 as a domestic for-profit corporation in Texas. Bennie Fuelberg and approximately seven other individuals representing different Cooperatives were listed as Directors. The purpose of organization for the entity was listed as:[487]

> *"The purpose or purposes for which the corporation is organized are to buy, sell, lease, own and operate personal and real property, and to engage in such other activities as corporations may lawfully engage in under the Texas Business Corporations Act."*

A January 1988 PEC Board resolution authorized Mr. Fuelberg "to pay the membership fee of $3,000 on behalf of Pedernales Electric Cooperative, Inc. for the Cooperative to become a member of the TEC Group VI Satellite Program."[488] Through Texas VI Satellite, PEC was able to offer cable television services to its members via satellite. The 1991 audited financial statements for Texas VI Satellite state that the entity "buys its television programming from National Rural Television Cooperative and sells it to satellite owners. In addition to this, the Company receives commissions on any satellite equipment sales to customers."[489] A detailed analysis of the Texas VI Satellite's financial and accounting records is beyond the scope of this investigation. In addition, historical records and information related to Texas VI Satellite dating back to its creation in 1988 are limited. However,

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[485] Letter from Bennie Fuelberg to Mr. Darren Schauer, General Manager Guadalupe Valley Electric Cooperative, Inc. Re: Wholesale Power Alliance, April 28, 2006.

[486] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 20, 2006 and Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 11, 2006.

[487] Articles of Incorporation of Texas VI Satellite, Inc., December 22, 1987.

[488] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., January 18, 1988.

[489] Texas VI Satellite, Inc. Audited Financial Statements, December 31, 1991.

based on the review of hard copy and electronic information and on discussions with current and former Cooperative personnel it is our understanding that PEC acted as a "sale and service agent" for Texas VI Satellite and that expenses incurred by PEC related to the sale of Texas Satellite VI services were reimbursed by Texas Satellite VI.[490,491] "Sale and service agents" also received sales and service commissions from Texas VI Satellite.[492] Texas VI Satellite remains an active corporation; however it is our understanding that PEC was no longer actively involved in Texas VI Satellite after 2001.

C. Observations and Findings

1. Purpose of Formation and PEC Affiliation

As described, we identified a business purpose for each of the entities affiliated with PEC. The Pedernales Water Supply and Sewer Service Corporation, PEC REP and LCRA REP were created by PEC for potential business ventures that ultimately were not pursued. The ALDC was organized by PEC, and PEC was a member of the group. Texas VI Satellite and the WPA were not organized or incorporated by PEC. However, we were able to determine that PEC was a member and active participant in the Texas VI Satellite program and that PEC was not a member of the WPA, but nonetheless assisted the WPA in its efforts through monetary contributions.

2. Limited or No Activity for Certain Related Entities

We identified little or no activity related to the Pedernales Water Supply and Sewer Service Corporation, PEC REP and LCRA Rep. As described, it is our understanding that these entities were established by PEC for business ventures that ultimately were not pursued. We have not identified any reasons or supporting information for the continued existence of these entities into 2007. In addition, we have identified no evidence of funds expended by the entities, or by the Cooperative on behalf of the entities, nor any evidence of separate bank accounts for the entities.

3. Board Knowledgeable of Establishment of Entities

As described, the PEC Board was aware of the establishment of these related entities and in a number of cases authorized or approved the creation of the entities. However, it is our understanding that the Board was unaware that several of the entities including the Pedernales Water Supply and Sewer Service Corporation, PEC REP and LCRA REP continued to remain active through 2007.

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[490] Shareholders Agreement – Texas VI Satellite, Inc., December 31, 1987.

[491] The Shareholders Agreement also allowed for the "sales and service agents" to charge customers fees for expenses not reimbursed by Texas VI Satellite.

[492] Shareholders Agreement – Texas VI Satellite, Inc., December 31, 1987.

D. Recommendations

Evaluate Strategic Need for Continued Existence of Entities

- It is recommended that PEC evaluate the strategic need for the continued existence of each of the related entities. In addition, to the extent PEC identifies any related entities with no existing or perceived future value, those entities should be terminated.

- It is also recommended that PEC update any public filings as needed for each of the related entities that is determined to have continuing use for PEC.

XXII. Employee Pay/Benefits – Non-Standard Practices

A. Background

Among the questions raised during the course of the class action lawsuit and through comments from Cooperative members, the media and others were issues regarding employment arrangements with certain former and current employees. The criticisms and questions related to payments to employees who were not providing services to PEC and to instances of informal severance packages provided to certain former employees.

B. Work Performed

1. Scope of Work

Included in the scope of Navigant Consulting's work was an evaluation and analysis of the employee arrangements for two employees identified during the course of the class action lawsuit. In addition, we reviewed and evaluated information in an effort to identify any other employees with similar arrangements. We also performed additional analyses to identify any other types of non-standard practices related to current and former employee compensation. For purposes of our analysis "non-standard" is defined as any practice that appears to have been outside the Cooperative's normal course of business.

More specifically, the scope of our work included the following:

- Identifying policies and procedures and evaluating internal controls related to non-standard employment and compensation arrangements, including extended pay and benefits, part-time or contract consultant arrangements and severance agreements.

- Identifying current and former employees with non-standard employment or compensation arrangements through reports provided by the Human Resources Department including employees whose "last paid date" was after their "termination" date and instances in which a "regular override" code was used by Human Resources personnel to continue compensation payments to certain employees.

- Identifying current and former employees with non-standard compensation arrangements through the review of Human Resources Department forms (Form 81 – Personnel Change Requests) used to document an employment status change.

- Identifying additional current and former employees with non-standard compensation arrangements through discussions with current and former PEC personnel.

- Reviewing and analyzing certain electronic and hard-copy information including but not limited to wage history reports, personnel change requests (Form 81s), severance/separation agreements, letters and other supporting documentation related to the apparent non-standard practices for the identified current and former employees.

- Identifying and reviewing available Human Resources information including personnel and benefit files for certain identified employees.
- Reviewing and analyzing retirement information including but not limited to "notice of intent to retire" forms and actuarial reports for identified former employees.
- Identifying and evaluating compensation and benefits information for certain identified employees, including Form W2s and various payroll, wage history and/or labor distribution reports.
- Identifying and evaluating Board resolutions and corresponding authorizations related to the compensation arrangements of certain current and former employees.
- Reviewing and analyzing reports and information indicating when an employee ceased making contributions to the 401(k) plan and when PEC stopped matching the contributions in the 401(k) plan for the employee.
- Reviewing and analyzing reports and information indicating when the Defined Benefit Retirement Plan stopped accruing benefits for the employee.
- Reviewing and analyzing reports and information regarding the calculation of employee retirement benefits from the Defined Benefit Retirement Plan.
- Conducting interviews with PEC personnel regarding the practices of the Human Resources Department and Mr. Fuelberg regarding terminated employees as well as circumstances surrounding the compensation arrangements with current and former employees identified for additional review.
- Conducting discussions with current and former employees regarding the circumstances surrounding their termination and/or retirement from PEC.

2. Limitations on Work Conducted

As described, given the ten-year scope of the investigation (1998 – 2007), certain requested information was not always available or reasonably accessible, especially with respect to the earlier years under review as a result of system conversions and other improvements. Because of employee departures, as well as PEC former management's propensity to rotate employees among various positions, we did not always find direct institutional knowledge with regard to certain employees and their arrangements. In addition, certain current and former employees interviewed were able to recall relevant facts and circumstances with only a limited degree of specificity.

3. Board Severance Policy and Operating Procedures

The following summarizes the various employment related policies and procedures at the Cooperative during the period under investigation that appeared relevant to our efforts.

The Cooperative's severance policy adopted by the Board in January 1990 states:[493]

> *"Upon written approval of the General Manager and when it is in the best interest of the Cooperative, an employee may be granted severance pay status. The severance pay status is granted to provide a period of adjustment for the employee upon termination of employment with the Cooperative. Annual Leave accrual, major medical insurance, dental insurance, AD&D, A&S, LTD, Life Insurance(s), and Retirement and Savings participation will be the only benefits and rights to continue during the period."*

A September 1999 letter to all managers from Mr. Fuelberg states:[494]

> *"When completing the Form 81 on an employee leaving the Cooperative, use the date the employee's pay is to end as the termination date. This date will also be used for the notification to benefit providers."*

PEC's Termination of Employment Operating Procedure revised in May 2000 states:[495]

> *"At its sole option, the Cooperative will provide two calendar weeks pay to employees terminating employment, provided that they have completed five months of employment. Requests for variations to this procedure must be made in writing from the employee's manager to the General Manager. (These employees will also receive benefit continuations during this period.) The last paycheck will be provided on the payday after this two week period. The General Manager's approval is required for involuntary terminations."*

PEC's Termination of Employment Operating Procedure was revised again in March 2002 to state: ."[496,497]

> *"The Cooperative will provide an additional two weeks of pay and extension of benefits in the event of an involuntary termination of a regular or newly hired full-time employee on full-pay status."*

> *"Newly hired or regular full-time employees on full-pay status who resign with two weeks notice should be released immediately and continue to receive two weeks of pay and extension*

493 Pedernales Electric Cooperative, Inc. Severance Policy adopted by the Board, January 15, 1990.
494 Letter from Bennie Fuelberg to All Managers, Subject: Terminations, September 21, 1999.
495 Termination of Employment Operating Procedure revised May 1, 2000.
496 Termination of Employment Operating Procedure revised March 19, 2002.
497 Termination of Employment Operating Procedure was revised again in February 2004 include employees who were on "full-pay status."

of benefits. The manager may choose to have the employee work through their two weeks notice. However, in that case benefits and pay will be continued two weeks from the last day worked"

4. Summary of Non-Standard Arrangements

We identified a number of employees during the period 1998 – 2007 who received non-standard employment and/or compensation arrangements with PEC. The non-standard employment and/or compensation arrangements involved employees of various employment status including active employees, retired employees, employees approaching retirement and employees who resigned or were terminated.

5. Non-Standard Arrangements for Active Employees as of December 31, 2007

Two individuals, Sandra Cunningham and Joyce Greenslade, were identified in various media articles and the class action lawsuit as active employees alleged to have provided few or no services to PEC but who had received compensation from PEC. Other than Mr. Burnett, who is discussed in detail in another section of the Report, we did not identify any other instances in which "active" employees were compensated but were believed to have provided few or negligible services to PEC.[498]

<u>*Sandra Cunningham*</u>

Ms. Cunningham was employed by the Cooperative for approximately fourteen years. She was hired in 1994 as an Economic Development Representative with an annual salary of approximately $35,588.[499] She was promoted to Coordinator in July 1998 and then to Manager of the Economic Development (later renamed Community Resources) Department in May 2001. She received a raise of $36,000 when she was promoted to Manager in 2001, which increased her annual salary to $93,496.[500]

Ms. Cunningham was transferred to the General Manager Department on July 24, 2006 and retained her title of Community Resources Manager and salary of over $141,785.[501,502] It appears that the Community Resources Department was renamed "Community Relations" in September 2006, and that Toni Reyes was appointed as the new manager and took over the day-to-day duties.[503]

[498] The term "Active employees" refers to employees of Pedernales Electric Cooperative, Inc. as of December 31, 2007.
[499] Wage History Report, Pedernales Electric Cooperative, Inc. for Sandra Cunningham.
[500] Wage History Report, Pedernales Electric Cooperative, Inc. for Sandra Cunningham.
[501] JD Edwards Employee Information Summary for Sandra Cunningham.
[502] Sandra Cunningham Personnel Change Request Form, February 1, 2008.
[503] Ms. Reyes was a long time Pedernales Electric Cooperative, Inc. employee who had managed a number of different departments during her tenure at Pedernales Electric Cooperative, Inc.

Ms. Cunningham was receiving an annual salary of $146,036 at the time of her resignation from PEC on February 1, 2008.[504] Ms. Cunningham did not meet the age or years-of-service requirements for participation in PEC's Defined Benefit Retirement Plan at that time and did not receive any retirement benefits.

Based on our review of hard-copy and electronic information and discussions with PEC personnel it appears that Ms. Cunningham provided limited services to PEC after her transfer to the General Manager Department in July 2006. In addition, it appears that she did not regularly work from an office at either PEC headquarters or a PEC building in any one of the PEC Districts after July 2006 and possibly earlier.

It appears that Ms. Cunningham's responsibilities prior to her transfer to the General Manager Department included economic development initiatives and grant writing assistance in the PEC service area. In addition, her responsibilities included organizing PEC events (e.g., golf tournaments) and employee and member giveaways (e.g., hats, calendars, pens). Ms. Cunningham's responsibilities changed after her transfer to the General Manager Department and remained consistent through 2007. It appears that she no longer was responsible for the economic development or grant writing assistance but kept her role related to Cooperative events and giveaways.

Ms. Cunningham apparently was involved during this time period with a company created by her and her husband called Keys To The Vault. It is also our understanding that her involvement with Keys To The Vault required extensive travel. She is currently listed as the Chief Executive Officer of Keys To The Vault. We have identified various records evidencing her travel for Keys To The Vault and communication with PEC related to business and non-business-related matters. It appears that Ms. Cunningham essentially coordinated the purchases of giveaways and event planning for PEC via e-mail and telephone through her assistant at PEC and through direct contact with vendors.

Ms. Cunningham received in excess of $249,000 in salary and bonus payments from the day she was transferred to the General Manager Department, July 24, 2006 through her retirement date of February 1, 2008.

Joyce Greenslade

Joyce Greenslade was hired by the Cooperative in May 1988 as an Executive Secretary with a starting salary of $21,632.[505,506] In November 1991, Ms. Greenslade was promoted to Secretary of the General Manager with a salary increase to $29,536. She remained the former General Manager's lead assistant through 2003. On or around December 2003, Ms. Greenslade's title was changed to "Archivist." Ms. Greenslade was compensated at a rate of $56,804 per year at the time of the change.[507]

[504] Sandra Cunningham Personnel Change Request Form, February 1, 2008.
[505] Pedernales Electric Cooperative, Inc. Wage History Report for Joyce Greenslade.
[506] Benefit Information and Election Form for Joyce Greenslade, March 17, 2008.
[507] Pedernales Electric Cooperative, Inc. Wage History Report for Joyce Greenslade.

Based on our review of hard-copy and electronic information and discussions with PEC personnel, it appears that Ms. Greenslade provided limited or no services to PEC after her title change and apparent change in position in December 2003. In addition, based on information reviewed, it appears that in or around the beginning of 2004 Ms. Greenslade spent a significant amount of time in Louisiana and was no longer effectively serving in the assistant role to the former General Manager.

It is our understanding that Ms. Greenslade may have left work for medical reasons. However, for some period of time following her designation as Archivist, Ms. Greenslade reportedly was available to PEC by telephone to locate items, recall details of corporate events, and otherwise function as an element of institutional memory for the Cooperative.

As a result of her medical issues, Ms. Greenslade filed for both short-term and long-term disability in or around March 2004.[508] Ms. Greenslade apparently encountered difficulties during the application process and in July 2004, Mr. Fuelberg "called Susan Burton (a Clark Thomas attorney)…and asked her to represent [Ms. Greenslade] on the Cooperative's behalf" in relation to her disability claims.[509] Ms. Greenslade's application for disability was ultimately denied in or around August 2004. In September 2004, Mr. Fuelberg instructed the Human Resources Manager to "reinstate Joyce Greenslade to her regular salary for the position of Archivist effective August 1, 2004."[510] Mr. Fuelberg stated that "this conforms to the Board's desires and replaces the Long Term Disability which was denied" and that it "is to remain in effect until May 1, 2008."[511,512] We have been unable to identify any Board minutes that further address Ms. Greenslade's situation or authorize the continued payment of her salary, despite the fact that she was no longer providing services to the Cooperative.

During the period January 2004 through August 2004, Ms. Greenslade took 51 sick leave hours, 224.5 vacation hours and 676.5 hours of "leave without pay."[513] She was compensated for her sick leave and vacation hours but not for her "leave without pay." In addition, Ms. Greenslade received a $74,000 bonus payment in or around February 2004.[514] It appears that she was accruing "leave without pay" hours until August 1, 2004 when Mr. Fuelberg requested that her hours be charged to General Ledger Account 819 – Salaries & Wages, an action that effectively returned Ms. Greenslade to the payroll, and gave the appearance that she was an active employee of the Cooperative.[515]

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[508] Letters from Fort Dearborn Life Insurance Company to Joyce Greenslade Re: Short term and long term disability benefits, March 16, 2004.
[509] E-mail from Renee Oelschleger to Joyce Greenslade, July 21, 2004.
[510] September 13, 2004 Letter from Bennie Fuelberg to Luis Garcia Re: Joyce Greenslade.
[511] September 13, 2004 Letter from Bennie Fuelberg to Luis Garcia Re: Joyce Greenslade.
[512] May 2008 would be the first month that Ms. Greenslade would be eligible for retirement benefits from Pedernales Electric Cooperative, Inc.
[513] 2004 Leave Without Pay Hours by Department Report.
[514] Pedernales Electric Cooperative, Inc. Wage History Report for Joyce Greenslade.
[515] Buckslip and attached handwritten notes, September 13, 2004

Ms. Greenslade's annual salary in August 2004 was $57,948. She received the annual cost of living adjustment in 2005 and 2006 increasing her salary to $59,696 in June 2006. Her salary was not adjusted again prior to her retirement in April 2008.[516]

Ms. Greenslade qualified for an "early retirement benefit" upon her termination date from PEC of April 30, 2008.[517] Ms. Greenslade selected a monthly benefit payment of $1,569.87.[518]

Ms. Greenslade received in excess of $318,000 in salary and bonus payments from the day she effectively went on leave of absence through her retirement date of April 30, 2008.

6. Retired Employees with Non-Standard Compensation Arrangements

Throughout the course of the investigation, we identified five retirees who had non-standard employment or compensation arrangements with the Cooperative.[519] While we have been unable to identify the specific reason for the non-standard arrangements in each instance, it is our understanding that Mr. Fuelberg would typically provide these arrangements to manager level personnel. Mr. Fuelberg appears to have used these arrangements as a way to reward certain employees for their years of service at the Cooperative. However, it is also our understanding that these arrangements would be provided to employees who Mr. Fuelberg wanted to replace or employees that were "sent home," but not fired, for performance-related issues.[520] Mr. Fuelberg frequently restructured his management team, which regularly included reassigning and relocating managers between the Departments and District offices. In addition, it appears that Mr. Fuelberg would demote managers and other employees to menial job functions in order to encourage the employee to resign instead of being fired. However, in certain instances it appears that Mr. Fuelberg would also "send home" an employee when another position was not available.

The identified employees were essentially paid for an additional period of time after the date the employee stopped providing services to PEC. The period of time typically ranged from two to ten months. In each instance, the actual retirement date listed in the Human Resources information systems (and forms) was the date at the end of the additional compensation period. In addition, in each instance, the retirement date used to calculate the employee's retirement benefits was the date at the end of the additional compensation period. Both of these uses of the extended retirement date were consistent with the instructions provided by letter from Mr. Fuelberg to the Cooperative's managers in 1999.

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[516] Pedernales Electric Cooperative, Inc. Wage History Report for Joyce Greenslade.

[517] Letter from Rudd and Wisdom, Inc. to Theresa Owens, Re: Joyce Greenslade, March 17, 2008

[518] Letter from Theresa Owens to Jamie Fertsch, April 14, 2008.

[519] We identified four (4) other retirees who also may have had a non-standard employment and compensation arrangement with Pedernales Electric Cooperative, Inc. However, due to insufficient information we were unable to determine with reasonable certainty that these retirees received special treatment from Pedernales Electric Cooperative, Inc.

[520] It is our understanding that in certain situations Mr. Fuelberg would "send home" employees instead of terminating their employment with Pedernales Electric Cooperative, Inc. These employees were told to not communicate with Pedernales Electric Cooperative, Inc. personnel or perform any Pedernales Electric Cooperative, Inc. related services until they were contacted by Mr. Fuelberg.

Although we have not been able to identify the exact date certain retirees ceased providing services to PEC, we have been able to estimate the date based on certain information provided including Form 81 – Personnel Change Request and Notice of Intent to Retire Forms and based on interviews with current and former PEC personnel. In addition, we have observed the use of a "regular override" code over a continuous period of time by Human Resources personnel for certain employees. Employees were responsible for inputting their own time sheets into PEC's system. However, the "regular override" code allowed Human Resources, as well as other, personnel to create a timesheet for an employee in the employee's absence. The timesheet was required for compensation purposes. In at least one other example, hard-copy documentation was available in which Will Dahmann informed the Human Resources Department that he had talked to the employee "about pay beyond his retirement date" and that PEC "[has] agreed to pay him for 4 months beyond his …retirement date."[521]

Data for the retirees who received non-standard employment and compensation arrangements including the estimated number of days of additional compensation for each are summarized below:

Retired Employees with Non-Standard Employment and Compensation Arrangements					
Employee Name	**Job Classification**	**Estimated Last Work Date**	**Last Pay Date**	**Days of Additional Pay**	**Ending Salary**
Arthur Borchers	District Manager	1/1/2004	10/31/2004	304	$ 137,656
Hubert D'Spain	Support Services Manager	1/5/2006	3/31/2006	85	133,561
Benny Jarvis	Project Maint. Manager	4/28/2006	9/1/2006	126	173,040
Jimmy Leinneweber	Account Services Manager	9/15/2003	12/1/2003	77	139,135
Will Martin	H.R. Manager	11/30/2005	10/1/2006	305	152,440

7. Retirees Allowed to Reach Retirement through Non-Standard Arrangements

We identified a number of retirees who continued to receive compensation and benefits from PEC after they ceased providing services to PEC. However, we identified only one retiree, in addition to Ms. Greenslade, who was allowed to qualify for retirement payments and benefits from the Defined Retirement Benefit Plan as a result of a non-standard compensation and employment arrangement. This employee did not provide any apparent services to PEC for approximately one year after being "sent home" by Mr. Fuelberg. Her employment was terminated with PEC in the month that she qualified for early retirement. Data for this retiree who was compensated without service up to retirement is summarized below:

Retiree Allowed to Reach Retirement through Non-Standard Compensation and Employment Arrangements					
Employee Name	**Job Classification**	**Estimated Last Work Date**	**Last Pay Date**	**Days of Additional Pay**	**Ending Salary**
Kerrigan, Diana	Advisory Manager	6/30/2000	6/30/2001	365	$ 95,826

[521] Buckslip from Will Dahmann to Theresa Owens, February 28, 2006.

8. Employees with Non-Standard Arrangements who Resigned or were Terminated

Throughout the course of the investigation, we identified approximately eighteen former employees who received non-standard employment and compensation arrangements when they resigned or were terminated. We have been unable to identify the specific reason for the non-standard arrangement in these instances. It is our understanding that, similar to the retirees, Mr. Fuelberg would provide these arrangements primarily at the manager level or for other more senior level personnel.

We have not been able to identify the exact date certain employees stopped providing services to PEC. However, as with the retirees, we have been able to estimate the date based on information including Form 81 – Personnel Change Request forms and the use of the "regular override" code in the time-reporting process. As with the retirees, the identified employees were essentially paid for an additional period of time after the date the employee stopped providing services to PEC. The period of time typically ranged from one to six months. In each instance, the actual retirement date listed in the Human Resource's information systems (and forms) was the date at the end of the additional compensation period.

With respect to these employees, we determined that six of the eighteen former employees entered into Separation Agreements or Severance Agreements that outlined the terms of their resignation from the Cooperative. Five of the six employees were managers and the other employee was a coordinator who received a written reprimand from Mr. Fuelberg on the day her Separation Agreement was signed.

The "Severance Pay" section in one of the Separation Agreements states:[522]

> *"The Company shall pay employee six months of wages excluding monthly vehicle allowance (less applicable taxes, F.I.C.A. and any other standard payroll deductions) which shall be considered Severance Pay. These sums combined shall be referred to herein as 'Consideration.' This Consideration shall be paid to employee according to the Company's normal payroll schedule. Additionally, the Company will continue to provide Employee the same health insurance, retirement benefits, and any other employee benefit she currently receives until…"*

In exchange for the severance pay, the employee was required to agree to release any claims against PEC, and to refrain from filing any lawsuits or making any disparaging remarks or statements about PEC.[523] The only significant differences between the six separation agreements related to the time period that each employee was to receive pay and benefits. The remaining employees appear to have been provided a similar severance benefit, but apparently without a formal agreement.

Data for the employees without separation agreements who received non-standard arrangements and their estimated number of days of additional compensation are summarized below:

[522] Separation Agreement and Release with Alexia Pearce, August 26, 2003.
[523] Separation Agreement and Release with Alexia Pearce, August 26, 2003.

Employees with Non-Standard Employment and Compensation Arrangements who Resigned or were Terminated (Without Separation Agreements)					
Employee Name	**Job Classification**	**Estimated Last Work Date**	**Last Pay Date**	**Days of Additional Pay**	**Ending Salary**
Donna Boykin	Accounting Coor.	8/30/2002	9/30/2002	31	$ 72,101
Susan Brymer	Training Supervisor	8/14/2006	11/7/2006	85	64,542
Melany Bushn	Accouting Clerk	1/15/2002	7/26/2002	192	24,296
Evelyn Clark	Call Receptionist	3/20/2002	4/3/2002	14	18,096
David Gajan	Associate Manager	8/31/2006	11/22/2006	83	81,515
Mary Garrett	Call Receptionist	8/31/2002	11/20/2002	81	19,968
William Higginbotham	Associate Manager	8/31/2006	11/22/2006	83	84,780
Stephen Barnes Maeker	Account Services Coor.	6/21/2004	8/31/2004	71	71,926
Van Mitchell	Associate Manager	8/31/2006	11/22/2006	83	84,780
Juan Santos	Account Services Coor.	1/11/2006	3/31/2006	79	62,670
Linda Talamantez	Associate Manager	8/31/2006	11/22/2006	83	84,780
Suzanne Thornburg	Associate Manager	11/15/2004	1/15/2005	61	71,926
Garfield Vassell	Training Supervisor	8/13/2007	11/11/2007	90	66,248

Data for the employees with separation agreements who received non-standard arrangements including the estimated number of days of additional compensation are summarized below:

Employees with Non-Standard Employment and Compensation Arrangements who Resigned or were Terminated (With Separation Agreements)					
Employee Name	**Job Classification**	**Estimated Last Work Date**	**Last Pay Date**	**Days of Additional Pay**	**Ending Salary**
Russell Adamiak	District Manager	1/23/2006	7/25/2006	183	$ 136,000
Jacqueline Blansfield	Accounting Coor.	9/15/2003	12/15/2003	91	80,683
Linda Brady	I.T. Manager	8/23/2001	2/23/2002	184	107,784
William Freeman	Emp. Develop. & Acct. Process Manager	8/6/2007	11/20/2007	106	139,048
Sheri Milner	Envision Manager	1/14/2002	4/15/2002	91	92,148
Alexia Pearce	Financial Manager	8/25/2003	2/28/2004	187	143,430

9. Additional Retirement Benefit for Retiree

In addition to Mr. Burnett, we have identified one retiree who received an additional retirement benefit from PEC. Hilda Kroll was hired by PEC in May 1964 and acted as the Board Secretary from at least 1968 through 1991.[524,525] It is our understanding that Ms. Kroll did not provide any services to the Cooperative other than Board secretarial services. Ms. Kroll was being paid $1,225 per month for her Board secretarial services when she retired from the Cooperative in 1991.[526] Upon her retirement, Ms. Kroll received a retirement payment from the Defined Benefit Pension Plan of approximately $85 and an additional payment of $514 per month from PEC's general asset fund.[527,528,529]

[524] Hilda Kroll – Employees Defined Benefit Retirement Plan Benefit Calculation.
[525] Wage History Report, Pedernales Electric Cooperative, Inc. for Hilda Kroll.
[526] Wage History Report, Pedernales Electric Cooperative, Inc. for Hilda Kroll.
[527] Letter from Deloitte & Touche to Nickie Cox, May 9, 1991.
[528] Letter from Deloitte & Touche to Nickie Cox, July 3, 1991.
[529] Letter from Bennie Fuelberg to Hilda Kroll, December 27, 1993.

Ms. Kroll initially elected to waive her participation in the Defined Retirement Benefit Plan when she was hired because her "initial salary was so low that it would not accrue a decent benefit."[530] At some point in 1986, Ms. Kroll's lack of participation in the Defined Retirement Benefit Plan was addressed by the Board. Action taken by the Board at a June 1986 Special Organization Meeting of the Board instructed Mr. Fuelberg, "to do what is necessary to provide coverage for Hilda Kroll, Secretary to the Board of Directors under the Retirement Plan of the Cooperative."[531] A month later, a July 1986 Board resolution provided "That at the time of retirement by Hilda Kroll from her employment by the Cooperative, an annuity will be purchased for her in an amount equivalent to what she would have received had she been included in the retirement plan during the entire length of her employment with the Cooperative, and further, that she be added to the present retirement plan of the Cooperative, effective January 1, 1987."[532]

It appears that the mechanics of the arrangement were changed at the time of Ms. Kroll's retirement. She was not to receive an annuity but would receive a payment from the Cooperative's general assets account. Ms. Kroll entered into a Retirement Payment Agreement in October 1991 which included a provision that required the Cooperative to "pay to Retiree… a monthly amount equal to… $514.72."[533] The agreement indicated that "in recognition of her long and faithful service, PEC decided and declared by Board Resolution (Resolution 8, July 21, 1986), as Retiree's retirement became imminent, to pay Retiree (and her Spouse) a special retirement payment… from PEC's general assets… as an addition to her retirement benefits from the plan in order for Retiree to receive from the combination of PEC and the Plan equivalent dollar benefits to those she would have received from the Plan if she had been a participant in the Plan for her entire career at PEC."[534]

Ms. Kroll received approximately $18,641 in payments from the Defined Retirement Benefit Plan and approximately $106,309 in supplemental payments from the Cooperative's general asset fund during the period 1991 - 2007. The yearly payments for the period 1998 – 2007 are summarized below.

Summary of Annual Retirement Payments to Hilda Kroll											
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
PEC General Asset Fund	$6,491	$6,491	$6,491	$6,491	$6,491	$6,491	$6,491	$6,491	$6,491	$6,491	$64,906
Defined Benefit Plan	1,075	1,075	1,075	1,075	1,247	1,247	1,247	1,247	1,247	1,247	11,783
Total	$7,566	$7,566	$7,566	$7,566	$7,738	$7,738	$7,738	$7,738	$7,738	$7,738	$76,688

10. Open Benefit Enrollment and Paycheck Verification Audit

The PEC Human Resources Department conducted open benefit enrollment meetings in June 2008. All full-time employees were "required to attend one of the meetings" and all employees were "required to sign up for the new life insurance" program.[535] In addition, the PEC Human Resources

[530] Hand written note regarding Hilda Kroll.
[531] Pedernales Electric Cooperative, Inc. Called Organization Meeting of Board, June 21, 1986.
[532] Pedernales Electric Cooperative, Inc. Board Resolution, July 21, 1986.
[533] Retirement Payment Agreement, Pedernales Electric Cooperative, Inc. for Hilda Kroll, October 21, 1991.
[534] Retirement Payment Agreement, Pedernales Electric Cooperative, Inc. for Hilda Kroll, October 21, 1991.
[535] Letter from Theresa Owens to all managers, May 22, 2008.

Department conducted a "paycheck verification audit" in October 2008. All employees were "required to present a photo ID… to receive their paycheck/advice on payday."[536] The Human Resources Department did not identify any "ghost" employees who did not sign up for insurance or did not pick up their pay checks.

11. Summary

While we have been unable to identify the specific reason for the non-standard employment and compensation arrangements for the retirees and former employees, it is our understanding that these arrangements were provided primarily to manager level employees and at Mr. Fuelberg's discretion. As described, in certain circumstances Mr. Fuelberg appears to have used these arrangements to reward employees for their years of service at PEC, while in others it appears that he would use these arrangements to "send home" an employee for performance issues when he was reorganizing or restructuring his management team.

C. Observations and Findings

1. Board Policy for Severance Payments to Employees

The 1990 Board policy granted Mr. Fuelberg authority to grant severance pay status to any employee at his discretion. This authority was broad in nature and did not establish any specific parameters for the payments, including the term over which they would be paid. Essentially, the severance program and policy was subjective and at Mr. Fuelberg's discretion.

The purpose of the Board policy was described as follows: "The severance pay status is granted to provide a period of adjustment for the employee upon termination of employment with the Cooperative."[537] As described, Mr. Fuelberg granted retirees non-standard employment and compensation arrangements that essentially provided payments to the employees after they stopped providing services to PEC. Mr. Fuelberg's program of granting certain retirees non-standard employment and compensation arrangements appears to have been a significant expansion of this Board authorization, although such an initiative might be argued to be within the general scope of his authority as General Manager.

2. Services Provided by Active Employees with Non-Standard Arrangements

We identified two active employees as of December 31, 2007 whose continuing employment was governed by a non-standard employment and compensation arrangement. Ms. Cunningham appears to have been working on a part-time basis, with limited presence at the PEC offices during the last year and one-half of her employment, yet she was compensated at a relatively substantial and full-time level during this period. Ms. Greenslade appears to have provided limited or no services to PEC from approximately January 2004 through December 2007, although she continued to be paid effectively as a full-time employee during this period. While it is not unusual for an organization to

[536] Paycheck Verification Audit, October 17, 2008.
[537] Pedernales Electric Cooperative, Inc. Severance Policy adopted by the Board January 15, 1990.

retain an employee with institutional knowledge for a period of time after the employee's effective cessation of full-time employment, the arrangement with Ms. Greenslade appears to have outlived its usefulness for PEC.

3. Employees Allowed to Qualify for an Early Retirement Benefit

We identified two PEC employees, Ms. Greenslade and Ms. Kerrigan, who were effectively given credit as full-time employees up to retirement age even though they were not in fact engaged in full-time employment service for a substantial period of the time in question. In both instances, the employees were not providing services to PEC under their non-standard compensation and employment arrangements and formally "retired" as soon as they were eligible for early retirement.

4. 401(k) Plan, Defined Benefit Retirement Plan and Health Benefit Plans

We identified five retirees and eighteen employees who resigned or were terminated who received a non-standard compensation and employment arrangement at the end of their tenure at the Cooperative. In each instance, the individuals were essentially paid for an additional period of time after the date the employee stopped providing services to PEC. In addition, as described, PEC treated these individuals as regular employees and thereby continued to allow the employees to contribute, and to commit the Cooperative to make matching contributions, to the applicable 401(k) plan. In addition these employees also apparently continued to accrue benefits under the Defined Benefit Retirement Plan.

The PEC Board Policy in effect during the investigation period did, however, allow continued accrual of certain benefits, notwithstanding the fact that a termination of active employment had occurred: "Annual Leave accrual, major medical insurance, dental insurance, AD&D, A&S, LTD, Life Insurance(s), and Retirement and Savings participation will be the only benefits and rights to continue during the period" of severance.[538] Thus it appears that the Board sanctioned continued participation in the Cooperative's benefit plans, including the 401(k) Plan, and Defined Benefit Retirement Plan, and Health Benefit Plans for severed employees.

The 401(k) Plan, Defined Benefit Retirement Plan and Health Benefit Plans are complex legal documents that contain numerous provisions addressing an employee's employment status. As a result, questions exist about what impact, if any, the non-standard employment and compensation arrangements (i.e., employee that is no longer providing service is participating in the plan), may have had in relation to the Defined Benefit Retirement Plan, 401(k) Plan and Health Benefit Plans.

5. Increased Retirement Benefit Payments for Retirees

We identified five retirees who received a non-standard compensation and employment arrangement at the end of their tenure at PEC. The employees were essentially paid for an additional period of time after the date the employee stopped providing services to PEC. As a result, the retiree's monthly retirement benefit payment may have been increased. The monthly retirement benefit

[538] Pedernales Electric Cooperative, Inc. Severance Policy adopted by the Board January 15, 1990.

payment calculation is based on, among other items, the years of service and the average monthly compensation based on the 36 months with the highest compensation.[539] As such, any additional period of time which an employee was compensated would result in increased years of service and increased average monthly compensation which would result in an increased monthly retirement benefit payment.

6. Board Approved Special Retirement Benefit for Retiree

As described, similar to the additional retirement benefit approved by the Board for Mr. Burnett, the Board was aware of and authorized the additional retirement benefit for Ms. Kroll.

D. Recommendations

Policy Regarding Non-Standard Agreements

- We identified two individuals for whom questions exist as to whether the compensation paid was justified relative to the level of service provided. In each instance, the non-standard arrangements appear to have been implemented at the discretion of the former General Manager and approved by the Board. However, while initial reasons may have existed for the non-standard arrangements, the length of service, as well as the total compensation paid under the non-standard arrangements, raises questions. It is recommended that PEC establish a clearly defined policy regarding non-standard agreements that addresses the following:

  » What circumstances may give rise to a non-standard employment or compensation agreement including limits on the length of term and level of compensation;

  » Guidelines to ensure adherence to existing retirement and health benefit plans;

  » What level of authority is required for approval and when information should be presented to the Board for approval; and

  » A clear tracking mechanism in the Human Resources Department to alert personnel to such arrangements for closer monitoring and adherence to other Cooperative policies, procedures, plans and guidelines.

Policy Regarding Severance/Separation Processes

- As described, the 1990 Board policy granted the former General Manager authority to grant severance pay status to any employee at his discretion. Essentially, the severance program and policy was relatively undefined and subject to Mr. Fuelberg's discretion. However, subsequent PEC procedures in 2000, and as amended in 2002, provide clear guidelines for both involuntary and voluntary terminations, which were limited to two-weeks of additional pay and benefits. While PEC appears to have a standard operating procedure for terminations, the 1990 Board resolution allowed the former General Manager to essentially

[539] Pedernales Electric Cooperative, Inc. Employees Defined Benefit Retirement Plan.

override that policy as he deemed appropriate. Given the inconsistency with which the severance agreement and pay appear to have been provided, it is recommended that PEC consolidate and redefine its policies regarding the termination of employees through either voluntary or involuntary means including addressing the following:

- » Identifying the circumstances under which separation agreements and severance pay are deemed appropriate;
- » Establishing the required level of authority to approve such agreements and pay and what decisions require Board approval; and,
- » Establishing acceptable terms and limits on severance pay and the extent to which participation in various retirement and benefit plans is allowed to continue.

- We also recommend that PEC improve its monitoring system in the Human Resources Department to keep track of employees who have been provided extended pay during a separation period and establish to what extent, or for how long, they are allowed to continue participating in Cooperative sponsored benefit and retirement plans.

Policy Regarding Informal Severance Agreements for Retirees

- Certain retirees were also granted non-standard compensation and employee arrangements that essentially provided payments to the employees after they stopped providing services to PEC. As a result, retirees were compensated for a period of time while they were not providing services to PEC and may have benefited from increased retirement payment benefits from the Defined Benefit Retirement Plan. It conjunction with recommendations cited above, in relation to non-standard employment and compensation arrangements, as well as terminations through voluntary means (i.e., retirement), it is recommended that either a separate policy be developed in relation to retirees or that appropriate sections in the referenced recommended policies be established to address the potential for non-standard arrangements with retirees. It is also recommended that the policy address other potential compensation to retirees, including the provision of supplemental retirement payments.

Evaluate Terms of Defined Retirement Benefit, 401(k), and Health Benefit Plans

- It is recommended that PEC, with the assistance of its outside advisor(s) to its Defined Benefit Retirement Plan, 401(k) Plan and Health Benefit Plans, evaluate the potential impact that non-standard employment and compensation arrangements may have had in relation to each of its plans, as well as revise or develop polices to ensure compliance with the plans on a prospective basis.

XXIII. Third Party Service Providers

A. Background

Throughout the course of the class action lawsuit and as a result of ensuing criticisms from Cooperative members, the media and others, questions were raised regarding the compensation paid to various outside consulting and third-party providers of professional services ("Third Party Service Providers") including various attorneys, lobbyists, and other consultants. The criticisms and questions focused on the total amount of payments to certain Third Party Service Providers, as well as the fact that many were compensated through the use of retainer instead of fee-for-service arrangements. Questions were also raised regarding the level and quality of services provided by certain Third Party Service Providers, including whether certain expenditures were reasonable and necessary in the conduct of the Cooperative's business.

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on evaluating PEC's relationships with various Third Party Service Providers, including summarizing compensation and expenses paid through PEC's General Ledger Account # 821 – *A&G-Contract Services* ("GL Acct. # 821") during the 1998 – 2007 time period. Inherent to our efforts was the review and evaluation of the various policies and procedures that the Board members and/or PEC management followed in engaging outside consultants.

Our investigation focused on select Third Party Service Providers, each of which received payments totaling over $60,000 during the period 1998 – 2007, as well as payments to other Third Party Service Providers that appeared unusual in nature. We also subjectively reviewed various other services and payments that appeared to be paid through retainer, or that otherwise raised questions regarding the services being provided. Greater emphasis was placed on individuals or entities who received retainer payments, versus fee for service, for an extended period of time. The Third Party Service Providers identified for review include the following:

- Ajilon
- Janette L. Barlow
- William Keaton Blackburn
- Clark Thomas & Winters
- Cunningham Public Relations
- Dublin & Associates Inc
- John Hall Public Affairs
- JD Power and Associates
- Management Applications Consulting
- Moody's Investors Service
- Kimberly J. Paffe Esq.
- Carl A. Parker PC

- Dudley C. Piland Jr. PE
- Rash & Associates
- Mark Rose
- Sedona Staffing Services
- David Sibley
- George B. Slade
- Kevin Smith
- Standard & Poors
- ViaNovo LP

More specifically, the scope of our work with regard to PEC's policies and procedures relating to the retention of various outside consultants, as well as our analysis of select Third Party Service Providers, included the following:

- Identifying and evaluating current and historical Board policies, including relevant Board minutes and resolutions relating to the retention of Third Party Services Providers.

- Identifying the relevant PEC General Ledger account(s) in which applicable Third Party Service Provider compensation and expenses were booked.

- Preparing a schedule summarizing payments to select Third Party Service Providers for the 1998 – 2007 time period from General Ledger Account # 821 – *A&G-Contract Services*.

- Identifying select Third Party Service Providers for additional detailed review through review of General Ledger Account # 821 – *A&G-Contract Services* and preliminary discussions with PEC personnel.

- Performing a detailed analysis of select Third Party Service Providers, including evaluation of authorization documentation (e.g., contracts, agreements, letters, resolutions), type of service provided, yearly compensation, payment type (e.g., retainer, fee for service), and termination date.

- Reviewing payment information retained by PEC relating to each Third Party Service Provider including Form 1099 submittals, invoices, and underlying support detail.

- Conducting interviews with PEC employees regarding the payment arrangements and services provided by select Third Party Service Providers.

- Evaluating total payments to select Third Party Service Providers relating to the service provided and its relevance to the overall business of the Cooperative.

Certain Third Party Service Providers were excluded from our detailed analysis because the services provided were readily known and accepted and we had no reasonable basis to question either the service provided or the respective cost of that service (e.g., Deloitte & Touche or JP Morgan Chase

Bank). Payments made to the various Moursund family-related entities were included in our analysis, but are addressed in a separate section of this Report.

2. Limitations on the Work Performed

Navigant Consulting's efforts in evaluating many of the Third Party Service Provider payments were limited by the lack of documentation, as well as the lack of institutional knowledge at PEC regarding the nature of the relationship between PEC and the Third Party Service Providers or the type of services being provided. As a part of Navigant Consulting's review, various records were requested including relevant contracts and/or retention agreements, as well as invoices and/or billing detail including the reports, memoranda or other communications summarizing the services provided. However, in many instances, PEC has relatively little information in its files to support some of the payments made, as well as the purpose for the payments.

While the limited information may be due in part to PEC's record-keeping, in many instances it is believed that certain Third Party Service Providers did not have signed contracts, did not provide invoices or billing statements, and did not otherwise present the conclusions or findings of their efforts in any style of written report. As will be discussed, certain of the Third Party Service Providers were retained primarily by Mr. Fuelberg and placed on a retainer basis with the Cooperative. Because most interactions in connection with these arrangements occurred between the respective Third Party Service Provider and Mr. Fuelberg, little appears to have been known either within PEC or among Board members about the nature of some of the agreements or payments being made.

As noted below, additional investigation relating to certain invoices of Clark, Thomas & Winters is ongoing.

3. Third Party Service Provider Retention Policy

During the course of our investigation we have identified only one documented Board policy related to the general retention of Third Party Service Providers. This was a May 2002 Board resolution that authorized the former General Manager to "employ such additional attorneys from time to time as he deems necessary to the conduct of the cooperative's business."[540] The resolution provides no guidelines or limitations on the former General Manager with respect to the vendor selection, the type or terms of agreements, payment methods, or compensation amounts.

It is generally neither common nor advisable for a Board to exercise detailed control over the retention of consultants by management in the ordinary course of business. Even so, there appears to have been no clear policy or consistent practice as to whether Mr. Fuelberg had an obligation to keep the Board informed about the individuals and firms he retained. As a result, the Board appears to have been unaware of either (i) the various retainers and compensation amounts paid to some Third

[540] Pedernales Electric Cooperative, Inc. Board Resolution, May 20, 2002.

Party Service Providers, who in certain instances received periodic, and in some cases substantial compensation over many years, or (ii) the nature of the services which they provided.

The retention of certain Third Party Service Providers is discussed in greater detail below.

4. Summary of Payments to Third Party Service Providers

The majority of the payments to Third Party Service Providers were booked to PEC's General Ledger under Account # 821 – *A&G-Contract Services* (GL Acct. # 821). Included under GL Acct. # 821 were payments made to a variety of Third Party Service Providers including attorneys, lobbyists, consultants, rating agencies, financial services and staffing companies. A detailed summary of the payments and expenses coded to GL Acct. #821 is attached as Exhibit 37.

Payments to certain Third Party Service Providers were also booked to other General Ledger accounts including, but not limited to, 188 - WIP-Dist Contractor Services, 820 - A&G-Office Supplies and 833 - A&G-Miscellaneous General Advertising. We focused on identifying all relevant payments to select Third Party Service Providers. These amounts and the amounts booked to GL Acct. # 821 for the select Third Party Service Providers addressed in the remainder of this section are summarized below for the period 1998 – 2007:[541]

Summary of Payments for Select Third Party Serivce Providers

Third Party Service Provider	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Clark Thomas & Winters	$490,313	$597,938	$848,147	$847,314	$1,318,578	$752,560	$1,124,196	$862,080	$866,535	$1,767,410	$9,475,072
Cunningham Public Relations	121,790	139,160	127,175	117,504	144,247	145,960	165,713	170,540	173,275	190,622	1,495,988
Kimberly J. Paffe	-	-	-	-	-	85,833	135,846	196,135	205,686	238,167	861,668
John Hall Public Affairs	73,977	75,668	93,344	81,092	74,595	74,499	74,528	74,562	74,530	74,440	771,235
David Sibley	-	-	-	-	43,027	60,000	60,000	61,443	61,398	60,000	345,868
Dudley C. Piland Jr.	-	-	-	-	-	-	-	-	52,083	251,430	303,513
Carl A. Parker	24,000	24,000	24,000	26,000	24,000	24,000	24,000	24,000	24,000	24,000	242,000
Mark Rose	-	-	-	33,332	66,934	-	-	-	-	-	100,266
William Keaton Blackburn	-	-	3,215	6,750	9,000	9,000	9,000	9,000	9,000	9,000	63,965
Total	**$710,081**	**$836,767**	**$1,095,880**	**$1,111,992**	**$1,680,381**	**$1,151,853**	**$1,593,282**	**$1,397,760**	**$1,466,508**	**$2,615,070**	**$13,659,573**

5. Analysis of Select Third Party Service Providers

Clark, Thomas & Winters

Clark, Thomas & Winters ("Clark Thomas") has been involved with PEC since the Cooperative's founding in 1938. Based on hard-copy and electronic information reviewed throughout the investigation, it appears that Clark Thomas has assisted PEC in a variety of legal areas over the years, including but not limited to general litigation and regulatory matters, financing and real estate transactions, employment disputes and internal investigations, pension and retirement planning, and tax and rate matters, as well as representing PEC in relation to the class action lawsuit. In addition, Clark Thomas attorneys and paralegals have attended PEC Board meetings, conducted general

[541] We were able to determine the service and the cost associated with the service provided by the other Third Party Service Providers identified for review. As a result, these Third Party Service Providers were not addressed in detail in the Report.

research on issues raised by management, and provided assistance with the LCRA contract negotiations, among other areas.

We have not identified any contracts or agreements between PEC and Clark Thomas that define its specific role or the relationship between the parties. However, a May 20, 2002 PEC Board resolution summarized Clark Thomas' role as follows:

> *Be it further resolved that the firm of Clark, Thomas and Winters continued to be retained as counsel for the Cooperative to represent it before regulatory agencies, administrative Boards and such other civil actions and tasks as may from time to time be authorized by Board Resolution or assigned by the General Manager.*[542,543]

In essence, Clark Thomas has served as Corporate Counsel for PEC for many years, as well as *de facto* outside General Counsel since at least 2002, if not earlier. Clark Thomas was compensated on a fee-for-service basis and has received in excess of $9.47 million from 1998 - 2007 for its PEC-related work. With the exception of 2007, during which significant work related to the class action lawsuit was done, Clark Thomas' total fees for services ranged on an annual basis from $490,313 to $1,318,578 since 1998, increasing approximately 74% from the average annual fees in the late 1990s to the annual average fees during the period 2000 - 2006.[544]

Clark Thomas' work was generally supported by invoices with descriptions of the services provided. In addition, the monthly payments to Clark Thomas were routinely listed, along with other vendor payments over $1,000, in the Board package materials provided to the Board members each month in advance of the regular monthly Board meetings.

During the investigation certain payments to Clark Thomas were identified in which the supporting invoices provided limited descriptions for the purpose of the payments. Included in these are various $30,000 payments to Clark Thomas between 1998 and 2003 totaling $360,000, and a $150,000 payment in December 2004. These invoices and payments are inconsistent with the pattern and nature of other invoices and payments to Clark Thomas during the period 1998 – 2007.

PEC's management was recently informed by representatives of Clark Thomas that payments, some of which appear to be linked to these invoices, were made by Clark Thomas on PEC's behalf to Mr. Fuelberg's brother, Curtis Fuelberg, a Texas lobbyist, and to then-Director E.B. Price's son, William Price, an attorney. Navigant Consulting's inquiry into these payments is ongoing and the scope of our efforts has been expanded to include a review of Clark Thomas' invoices prior to 1998, as well as a more detailed review of its invoices during the period 1998 – 2007. Our observations and findings with regard to these payments are ongoing and will remain an open item for purposes of this Report.

[542] Pedernales Electric Cooperative, Inc. Board Resolution, May 20, 2002.

[543] This Board Resolution was reaffirmed by a September 19, 2005 Board Resolution.

[544] 2007 was excluded due to the fees paid to Clark Thomas associated with the class action lawsuit.

Clark Thomas is currently representing PEC in the Worrall class action lawsuit. Clark Thomas' retention in that matter was reaffirmed by Board resolution in August 2008, to the effect that "…the continued retention of Clark Thomas & Winters as legal counsel be affirmed and that General Manager Garza is instructed to assist legal counsel on behalf of the Cooperative in support of the settlement agreement reached in the Worrall litigation."[545]

In summary, it appears that the Cooperative, and primarily Mr. Fuelberg, utilized Clark Thomas quite extensively throughout the period of investigation for a variety of reasons, as outlined above, including attendance at Board meetings and various Board retreats and management meetings. Although PEC had retained an in-house Legal Services Manager, Mr. Luis Garcia, in November 2002, Mr. Garcia was subsequently reassigned as interim manager of PEC's Human Resources Department in September 2003, and then as manager of PEC's IT Department in April 2005. Mr. Garcia remained in that position until recently when he was assigned as interim General Counsel by Juan Garza in September 2008.

While the Moursund Law Firm was also designated as General Counsel and paid a retainer for its services in that role, it appears that the Moursund Law Firm was primarily providing limited consultation at Board meetings and limited service related to PEC's bad debt collection. In addition, Kimberly Paffe was also retained in a legal services role; it appears, however, that the services she provided during the investigation period were limited to a few specific areas. Our analysis relative to Ms. Paffe and the Moursund Law Firm are discussed below, and in a separate section to this Report, respectively.

In the absence of an in-house General Counsel, who otherwise would have been expected to provide advice and counsel to Mr. Fuelberg and the Board on various matters, PEC appears to have relied heavily on Clark Thomas to fulfill that role.

Kimberly Paffe

Kimberly Paffe was hired as an independent contract attorney and became "legal counsel" for PEC effective September 15, 2003.[546,547] Ms. Paffe was included in the scope of our investigation because the basis of her employment and compensation was different from that of other PEC employees. Ms. Paffe's annual salary or retainer amount as an independent contractor was initially set at $160,000 per year, which was larger than that of all but three individuals at the Cooperative. We were told that Ms. Paffe was hired on a short-term basis to replace Mr. Garcia, who had been reassigned as the manager of PEC's Human Resources Department. However, Ms. Paffe remained in the role of an independent contractor during the 2003 – 2007 time period.

No formal Board resolution authorizing the retention of Ms. Paffe has been identified other than the general May 2002 Board Resolution authorizing Mr. Fuelberg to "employ such additional attorneys

[545] Pedernales Electric Cooperative, Inc. Board Resolution, August 18, 2008.

[546] Letter from Bennie Fuelberg to All Managers, Re: New Assignments, September 8, 2003.

[547] It is our understanding that Ms. Paffe was hired as an independent contractor because she was unable to adhere to certain Pedernales Electric Cooperative, Inc. policies due to other obligations (i.e., Ms. Paffe was unable to be at the Johnson City Headquarters building from 8:00 – 5:00 each day).

from time to time as he deems necessary…"[548] In addition, no employment agreements and/or contracts appear to have existed in relation to Ms. Paffe's service to PEC during the period under investigation.

Ms. Paffe's initial pay was set at $13,333.33 per month in September 2003, equal to total annual compensation of $160,000. Ms. Paffe's compensation was increased in June 2004 to $14,000 per month, or $168,000 per year. Her compensation remained the same until August 1, 2007, when her compensation was increased 50% to $21,000 per month, or $252,000 per year. Ms. Paffe also received a monthly car allowance from PEC that started at $1,000 per month and was subsequently increased to $1,200 per month in March 2006.[549] In addition, Ms. Paffe was paid various bonuses including several mid-year and year-end Christmas bonuses.[550] The total payments provided to Ms. Paffe are summarized below:

Summary of Payments to Kimberly Paffe

	2003	2004	2005	2006	2007	Total
Retainer	$80,000	$124,000	$168,000	$168,000	$203,000	$743,000
Car Allowance	-	4,000	12,000	15,000	14,400	45,400
Bonus	2,500	7,000	14,500	17,500	12,000	53,500
Other	3,333	846	1,635	5,186	8,767	19,768
Total	**$85,833**	**$135,846**	**$196,135**	**$205,686**	**$238,167**	**$861,668**

Even though Ms. Paffe was an independent contractor, she did not submit invoices to PEC. In addition, although she had the nominal status of a department manager, she did not fill out any sort of timesheet, as required of PEC employees, a distinction that could relate to her role as an attorney. Ms. Paffe's payment was set up in PEC's accounting system as a recurring payment. The payments were authorized by Mr. Fuelberg as evidenced by multiple letters from Mr. Fuelberg to the Finance Department directing them to make payments to Ms. Paffe.[551] Ms. Paffe received over $861,000 during the approximate 4 ½ years she worked at PEC during the investigation time period (i.e., from 2003 to 2007).

While the Board was familiar with Ms. Paffe and her role, it is unknown whether the Board was aware of the amount of her monthly payments, her status as an independent contractor, or the fact that she was paid a car allowance and periodic bonuses (even as a contractor). The monthly retainer and car allowance payments do appear to have been included in the list of checks provided to the Board members each month as a part of the Board packages in advance of the Board meetings. However, after August 2007, and upon the increase in her compensation to $21,000/month, those amounts were no longer included in the list of checks.

Ms. Paffe's relationship with PEC continued into 2008 and was formalized in an "Employment Agreement" dated February 1, 2008, which was executed by Ms. Paffe and Mr. Fuelberg. Subject to

[548] Pedernales Electric Cooperative, Inc. Board Resolution, May 20, 2002.

[549] August 20, 2004 Letter from Kimberly Paffe to Bennie Fuelberg.

[550] Letter from Bennie Fuelberg to Mike Vollmer, Re: Bonus Request, June 1, 2006.

[551] Letter from Bennie Fuelberg to Mike Vollmer, Re: Payment Continuation for Kimberly Paffe, April 13, 2004. Memo to Accounting, Paffe Employment File, Re: Monthly pay rate for contract legal services, June 7, 2004.

the Employment Agreement, Ms. Paffe became an employee of PEC and was named "General Counsel to the PEC Board of Directors." The agreement had a two-year term and included an annual salary of $200,400, a $1,200 monthly car allowance, and reimbursement for out-of-pocket expenses.[552]

Ms. Paffe's role and compensation with PEC were jointly amended by Mr. Garza and Ms. Paffe in 2008. Effective September 1, 2008, Ms. Paffe was no longer General Counsel of PEC and she accepted a corresponding reduction in her annual compensation from the Cooperative to $150,000, as well as the elimination of her car allowance.

Cunningham Public Relations

Cunningham Public Relations is a public relations company owned and operated by Billy Cunningham. It is our understanding that Mr. Cunningham is the sole employee of the company. Based on discussions with Mr. Cunningham and PEC personnel, Mr. Cunningham's association with PEC began in or around 1982 with his provision of public relations services to Texland Electric Cooperative in its efforts to develop a power generation facility.[553] Prior to that time, Mr. Cunningham had worked with Mr. Burnett when Mr. Burnett was a Judge in Hays County.

Mr. Cunningham became more involved with PEC in 1983. An August 1983 PEC Board resolution authorized Mr. Fuelberg "to negotiate with Bill Cunningham, to retain the services of Mr. Cunningham on an 'As Necessary' basis to perform public relation services for the Cooperative at such fee as he deems appropriate."[554] A 1986 Board resolution subsequently authorized the continued retention of Mr. Cunningham at $50 per hour plus twenty cents per mile mileage and expenses.[555]

Mr. Cunningham provided various public relations services to PEC over the years, including creating the PEC newsletter, drafting press releases, and coordinating press inquiries and responses among other responsibilities. In addition, Mr. Cunningham attended PEC Board meetings and retreats, management meetings and retreats, and conferences as a representative of PEC.

Mr. Cunningham submitted invoices and received a monthly payment from PEC since at least 1988 through December 2007.[556] The invoices indicated that Mr. Cunningham was compensated hourly by PEC and included the number of hours he worked each month. Mr. Cunningham's rate for the period 1998 – April 2002 time period was $60 per hour. During this period, his number of hours worked each month averaged 164 and his monthly compensation averaged $10,619. During May 2002 – October 2002, Mr. Cunningham's hourly rate was adjusted to $150 per hour. During this time period the invoiced number of hours worked by Mr. Cunningham averaged 69 hours and his monthly compensation averaged $11,304. In November 2002 and continuing until December 2007, Mr. Cunningham's hourly rate was adjusted to $200 per hour. However, at the same time the average number of hours he worked decreased to around 62 hours per month and his monthly

[552] Employment Agreement between Kimberly Paffe and Pedernales Electric Cooperative, Inc., February 1, 2008.
[553] Mr. Cunningham's involvement in Texland is addressed in more detail in a later section of this Report.
[554] August 15, 1983 Board Resolutions.
[555] Pedernales Electric Cooperative, Inc. Board Resolution, June 21, 1986
[556] General Ledger data is only available from 1988 forward.

compensation averaged $13,823. As a result, while Mr. Cunningham's number of hours decreased by over 100 per month (or over 60%) his average monthly compensation during the three time periods did not change significantly.

Based on the hard-copy and electronic information reviewed and interviews conducted throughout the investigation, we were unable to identify any historical contracts or agreements with Mr. Cunningham that define his role or relationship with PEC during the investigation period, including information related to the hourly rate increase in 2002 other than the Board resolutions described above which referenced "public relation services."

The Board was aware of Mr. Cunningham's role and the general types of services he provided to PEC. As described, Mr. Cunningham regularly attended Board meetings and retreats and management meetings and retreats. In addition, the monthly payments to Mr. Cunningham were listed in the Board package each month in the section listing checks over $1,000.[557]

Mr. Cunningham also received reimbursements from PEC for out-of-pocket expenses. These expenses were not detailed on the invoices submitted by Mr. Cunningham, rather they were included as a lump sum item with the notation that they were for "meals, transportation, misc. expenses."

Mr. Cunningham's relationship with PEC continued into 2008 and was formalized in a "Consultant Agreement" dated January 29, 2008 executed by Mr. Cunningham and Mr. Fuelberg. The agreement included a monthly retainer of $12,000 plus out-of-pocket expenses and a one (1) year term.

The consulting services to be provided by Mr. Cunningham under the 2008 agreement included the following:[558]

- *"Represent the Board of Directors of PEC as the Board's official spokesman;*
- *Consult with and advise the officers and Directors of PEC concerning public and press relations;*
- *Represent PEC at events and meetings at both state, regional and national levels at the discretion of the Board of Directors;*
- *Coordinate with the marketing division and in-house publications personnel of PEC on activities regarding PEC;*
- *Carry out such other duties as the Board of Directors of PEC may assign."*

While the services provided by Mr. Cunningham to the Cooperative over the years are documented and supported by monthly invoices, a number of persons, including members of the Board,

[557] This section was later changed to checks over $2,500.
[558] William Cunningham Consulting Agreement January 29, 2008.

questioned his compensation relative to the services and value of service he provided to the Cooperative.

In April 2008, Mr. Cunningham voluntarily amended his contract to change his reporting relationship from the Board to the new General Manager, Mr. Juan Garza.

John Hall Public Affairs

John Hall Public Affairs received payments from PEC since at least 1998 and was compensated via a monthly retainer through 2007. John Hall Public Affairs was a consulting firm solely owned by Mr. John Hall. Mr. Hall was a former Chairman of the Texas National Resources and Environmental Conservation Commission, and an executive at LCRA, with expertise in water and natural resources environmental issues. A June 1995 Board Resolution ratified "the actions of General Manager Fuelberg in hiring John Hall as a consultant for the Cooperative be and are hereby ratified."[559] No additional details were included in the resolution including the amount of compensation to be paid to Mr. Hall or the term of his retention.

Based on the hard-copy and electronic information reviewed, as well as interviews conducted during the investigation, we were unable to determine what specific services, if any, Mr. Hall has provided to PEC over the past ten years. In addition, we have not identified a contract or agreement with Mr. Hall that further defined his role or relationship with PEC. We were not successful in contacting Mr. Hall to make further inquiry regarding the nature of his services to PEC.

Mr. Hall received a monthly $6,000 retainer payment and out-of-pocket expenses during the period 1998 – 2007 for a total of $771,235. Mr. Hall submitted monthly invoices to PEC for payment of his retainer and out-of-pocket expenses. The invoices did not include detailed information about the services provided or the time spent by Mr. Hall on PEC related matters, nor did the invoices itemize the expenses incurred by Mr. Hall.

Based on discussions with PEC Directors and other personnel, it appears that the Directors and PEC personnel were unaware of the services that Mr. Hall was providing to PEC during this time period and that he was receiving a monthly retainer payment. However, the monthly retainer payments to Mr. Hall were listed in the Board package each month in the section listing checks over $1,000.[560]

Mr. Hall's relationship with PEC was terminated by Mr. Garza in April 2008.[561]

Carl Parker

Carl Parker received payments from PEC since at least July 1994 and was compensated via a monthly retainer through 2007.[562,563] Mr. Parker is an attorney and lobbyist and a former legislator in Texas

[559] Pedernales Electric Cooperative, Inc. Board Resolution, June 19, 1995.
[560] This section was later changed to check over $2,500.
[561] Letter from Mr. Garza to Mr. Hall, April 23, 2008.

who served in both the Texas House and the Texas Senate for a combined period of over 30 years. A June 1994 Board Resolution authorized that "Senator Parker's retainer fee be increased from $1,000 per month to $2,000 per month."[564] No additional details were included in the resolution including the term of Mr. Parker's retention. We have not identified a resolution authorizing the retention of Mr. Parker.

Based on the hard-copy and electronic information reviewed, as well as interviews conducted during the investigation, we were unable to determine what services, if any, Mr. Parker provided to PEC during the period 1993 – 2007. Nor were we able to identify any contract or agreement with Mr. Parker that further defined his role or relationship with PEC. Upon being contacted in connection with the investigation, Mr. Parker provided information to the effect that his retainer was paid to him for his availability as an advisor and for consultations he provided to PEC in connection with "keeping up politically with goings-on in Austin." He remembers having helped PEC in connection with a rate hearing, and advising them and gathering information in connection with several disputes with LCRA. He also helped PEC General Counsel A.W. Moursund in various ways to assist in meeting PEC's objectives.

Mr. Parker received a monthly $2,000 retainer payment from PEC from July 1994 through 2007, for a total of approximately $324,000 ($2,000 x 162 months). Mr. Parker did not submit invoices to PEC detailing the services provided or work performed on behalf of the Cooperative. Mr. Parker was not reimbursed for any out-of-pocket expenses.

Based on discussions with PEC Directors and other personnel, it appears that the Directors and PEC personnel were unaware of the services that Mr. Parker was providing to PEC during this time period and that he was receiving a monthly retainer payment.

Mr. Parker's relationship with PEC was terminated in June 2008.

Mark Rose

Mark Rose received payments from PEC beginning in October 2001 and continuing until August 2002. A September 2001 Board resolution authorized Mr. Fuelberg to "hire Mark Rose as a consultant" of PEC.[565] No additional details were included in the resolution including the amount of compensation to be paid to Mr. Rose or the term of his retention. Mr. Rose is currently the General Manager of Bluebonnet Electric Cooperative and was the former General Manager of LCRA prior to his retention as a consultant with PEC.

Based on the hard-copy and electronic information reviewed, as well as interviews conducted during the investigation, we were unable to determine what services Mr. Rose was providing to PEC during the period 2001 – 2002. In addition, we have not identified a contract or agreement with Mr. Rose

[562] Letter from Mr. Fuelberg to Patrick Pesek Re: Senator Parker, September 16, 1994.
[563] Law Offices of Carl Parker Invoice, January 6, 1993.
[564] Pedernales Electric Cooperative, Inc. Board Resolution, June 20, 1994.
[565] Pedernales Electric Cooperative, Inc. Board Resolution, September 17, 2001.

that further defined his role or relationship with PEC. When contacted in connection with the investigation, Mr. Rose stated that his engagement with PEC was to be for one-year, and that his duties involved consultation regarding a broad range of management and political issues, including LCRA's plans for generation and other available options for PEC, PEC's response to de-regulation of the Texas electric industry, potential acquisitions for PEC, and other areas of advice in which his expertise provided appropriate background. Mr. Rose stated that he was comfortable acting as a consultant to PEC in connection with LCRA matters because his engagement commenced more than one year after his departure from LCRA. According to Mr. Rose, at his own request, the PEC engagement was not renewed at the end of its one-year term.

Mr. Rose received monthly retainer payments of $8,333 during the period 2001 – 2002, for a total of $100,265.72. Mr. Rose submitted monthly invoices to PEC. However the invoices did not include any detail outlining the services provided.

Based on discussions with PEC Directors and other personnel, Mr. Rose's retention by PEC was generally known to the Board and others. We were told that Mr. Fuelberg believed his prior experience with LCRA might prove beneficial to PEC. However, none of the Directors or other PEC managers have any specific recollection as to the nature of the services provided by Mr. Rose. As with many of the previously described consultants retained by Mr. Fuelberg, there appears to have been little understanding of the nature of the services provided by these consultants outside of their interaction with Mr. Fuelberg, and possibly Messrs. Burnett and Dahmann.

Payments to Mr. Rose ceased in August 2002.

David Sibley

David Sibley is a lobbyist and former Texas State Senator. Mr. Sibley began receiving a monthly $5,000 retainer from PEC in 2002 which continued through 2007. The PEC Board authorized Mr. Fuelberg to "hire Senator David Sibley as a consultant on behalf" of PEC in August 2002.[566] No additional details were included in the resolution, including the amount of compensation to be paid to Mr. Sibley or the term of the retention.

Mr. Sibley was apparently retained by PEC in 2002 in relation to PEC's bond offering that was closed in October 2002. An invoice submitted to PEC by Mr. Sibley in July 2002 included a $20,000 fee for "legal services" with the explanation of "bond rating." In addition, the invoice and attached receipts indicate that Mr. Sibley traveled to New York on behalf of PEC to meet with a rating agency.[567] A letter from Mr. Fuelberg to the Board in September 2002 indicated that Mr. Sibley's "explanation of deregulation has as much to do with our ratings as did our margins."[568] As a former State Senator, Mr. Sibley was a key sponsor of the Texas legislation, Senate Bill 7, passed in 1999, that resulted in the restructuring of the Texas retail electric industry.

[566] Pedernales Electric Cooperative, Inc. Board Resolution, August 19, 2002.
[567] David Sibley Invoice, July 2002.
[568] Letter from Bennie Fuelberg to Board of Directors Re: AA- Ratings, September 23, 2002.

As referenced, in addition to the $20,000 payment for Mr. Sibley's work related to the bond offering, Mr. Sibley began receiving a monthly $5,000 retainer payment in September 2002 which continued into 2008.[569] Mr. Sibley received a total of approximately $320,000 in retainer payments during the period 2002 - 2007. Additional expense payments were made to Mr. Sibley during 2002, 2005 and 2006, as evidenced in PEC's general ledger. Mr. Sibley did not submit invoices to PEC after his initial invoice. The $5,000 monthly retainer payment was set up in the PEC accounting system as a recurring payment.[570]

Based on the hard-copy and electronic information reviewed, as well as interviews conducted during the investigation, Mr. Sibley appears to have been actively engaged in providing services to PEC during the period 2002 – 2007, including assisting PEC with bond related matters, as well as periodically attending Board meetings. In addition, Mr. Sibley stated that the services rendered by him to PEC related to consulting in regard to legislative and electric industry matters. We did not identify a contract or agreement with Mr. Sibley that further defined his role or relationship with PEC during this time period.

Mr. Sibley's relationship with PEC continued into 2008 and was formalized in a "Consulting Agreement" dated January 28, 2008 executed by Mr. Sibley and Mr. Fuelberg. The agreement included a monthly retainer of $7,000 plus out-of-pocket expenses and a one (1) year term. The consulting services to be provided included representation "before the state of Texas on matters relating to the regulation of electric cooperatives in the State of Texas."[571] While Mr. Sibley's general role was understood by the Board, the timing of his Consulting Agreement in 2008, as with Mr. Cunningham's, might be perceived to be an attempt by Mr. Fuelberg to protect and benefit certain of his long-standing relationships. Mr. Sibley was nevertheless viewed by Board members and others as providing appropriate value for his compensation as a consultant during the investigation period.

William Keaton Blackburn

William Keaton Blackburn "acted as counsel to Kimble Electric Cooperative, Inc. in connection with the sale of Kimble's assets to PEC."[572] Mr. Blackburn has been described as Kimble Electric Cooperative's General Counsel. After completing the acquisition, PEC retained Mr. Blackburn and paid him a monthly retainer of $750 beginning in April 2001 and continuing until 2007, a total of $60,750. In addition, he received payments of $2,759 in August 2000 and $456 in December 2000. Based on the hard-copy and electronic information reviewed, as well interviews conducted during the investigation, we were unable to determine what services Mr. Blackburn provided to PEC during the period 2001 – 2007. In addition, we have not identified any historical Board resolutions or contracts/agreements with Mr. Blackburn that define his role or relationship with PEC.

[569] Letter from Bennie Fuelberg to Alexia Pearce, September 17, 2002.
[570] David Sibley Recurring Monthly Check Form.
[571] Consulting Agreement between David Sibley and Pedernales Electric Cooperative, Inc., January 28, 2008.
[572] Letter from William Keaton Blackburn to Pedernales Electric Cooperative, Inc., July 14, 2000.

Based on discussions with PEC Directors and other personnel, it appears that the Board and PEC personnel were unaware of the services that Mr. Blackburn was providing to PEC during this time period or that he was receiving a monthly retainer payment.

Mr. Blackburn's relationship with PEC continued into 2008 and his contract is currently under review by PEC management.

Dudley C. Piland, Jr.

In July 2006, the PEC Board authorized Mr. Fuelberg to "hire Dudley Piland as a PEC Contractor."[573] No additional details were included in the resolution including the amount of compensation to be paid to Mr. Piland or the term of his retention. Mr. Piland had previously been employed as an executive by LCRA with responsibility for electric generation and power supply operations at LCRA. Mr. Piland entered into a "Consulting Services Agreement" with PEC effective October 16, 2006.[574] The agreement was executed by Mr. Piland and Mr. Fuelberg. The services outlined in the agreement included:

- *"Consultant shall provide technical and managerial expertise and consultation to assist PEC to make decision on power supply options.*

- *Consultant shall continue to maintain industry expertise and current with industry changes.*

- *Consultant shall provide other services to Company as mutually agreed and documented as an addendum to this Statement of Work."*[575]

Mr. Piland's compensation was outlined in the agreement as "$250,000 each year for the first two years… in equal monthly payments." As a result, Mr. Piland received a monthly retainer payment of $20,833. During the term of his consulting agreement, Mr. Piland appears to have provided limited consulting services to PEC's engineering department. Mr. Piland received a total of $303,512.90 during the 2006 - 2007 time period. However, Mr. Piland did not submit invoices to PEC. Mr. Fuelberg instructed the Finance department to issue equal monthly payments to Mr. Piland and that the "compensation fees will be reviewed after two years."[576]

Mr. Piland's relationship with PEC continued into 2008 and his contract is currently under review by PEC management.

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[573] Pedernales Electric Cooperative, Inc. Board Resolution, July 17, 2006.

[574] Consulting Services Agreement between Dudley Piland, Jr. and Pedernales Electric Cooperative, Inc. October 16, 2006.

[575] Consulting Services Agreement between Dudley Piland, Jr. and Pedernales Electric Cooperative, Inc., October 16, 2006.

[576] Letter from Bennie Fuelberg to Mike Vollmer Re: Payments for Dudley Piland, November 6, 2006.

6. Third Party Service Provider Benefits

In addition to the compensation received, certain Third Party Service Providers and their spouses were extended a specialized benefit by allowing them to receive physicals from the Cooper Clinic, a well-known and highly regarded medical clinic specializing in preventive medicine in Dallas, Texas. Two Third Party Service Providers and a spouse received physicals from Cooper Clinic during the period 2003 – 2007 at a cost of $15,367 paid by the Cooperative.

The benefit extended to these individuals and one of their spouses appears to have been beyond the scope of Board resolutions authorizing the Cooper Clinic benefit. By Board resolution dated January 20, 2003, the Board authorized the payment of physicals for senior management and the Board through the Cooper Clinic. A similar resolution was approved again on July 18, 2005, followed by a resolution extending the privilege to include spouses of the PEC Board and Senior Management. We have not identified a Board resolution or other documentation that authorized Third Party Service Providers the same Cooper Clinic benefit as the PEC Directors and Managers.

The Board terminated paying for expenses related to physical examinations through the Cooper Clinic effective March 20, 2008. The Cooper Clinic benefits received by the PEC Directors and managers are addressed in more detail in another section of this Report.

C. Observations and Findings

1. Clark Thomas & Winters Role as De Facto General Counsel

A.W. Moursund and The Moursund Law Firm also provided legal services and advice to PEC during the 1980 – 2007 time period. We have not identified a formal contract or agreement that outlined Clark Thomas' responsibilities during this time period other than a May 20, 2002 Board Resolution that outlined Clark Thomas' continued retention "as counsel for the Cooperative to represent it before regulatory agencies, administrative Boards and such other civil actions and tasks as may from time to time be authorized by Board Resolution or assigned by the General Manager."[577,578]

Based on the electronic and hard copy information reviewed and discussions with PEC personnel, it appears that Clark Thomas essentially functioned as General Counsel for PEC. Clark Thomas was regularly consulted by PEC management on a number of matters including employment, regulatory and litigation-related matters. It is unclear why PEC and the Board felt it was necessary to have essentially two General Counsels in the form of Clark Thomas and A.W. Moursund (and later the Moursund Law Firm) and to compensate them at the rates they received.

A.W. Moursund and The Moursund Law Firm's involvement with PEC is addressed in greater detail in another section of this Report.

[577] Pedernales Electric Cooperative, Inc. Board Resolution, May 20, 2002.
[578] This Board Resolution was reaffirmed by a September 19, 2005 Board Resolution.

2. Kimberly Paffe's Role as an Independent Contractor

Federal tax guidelines make a distinction between whether an individual is an independent contractor or an employee. In addition, the courts have considered many factors in deciding whether a worker is an independent contractor or employee. The IRS has outlined 20 factors that bear upon establishing independent contractor status. However, these factors fall into three main categories related to control and the relationship between the parties. Chief among these is whether:

- The employer has a right to direct or control how the worker does the work.
- The worker is not reimbursed for some or all of their expenses and can incur a profit or a loss on the work performed.
- The worker receives employee benefits.
- Whether a written contract exists.

Based on our understanding of Ms. Paffe's role, it is questionable whether the nature of her work for PEC over her four-to-five-year tenure during the investigation period qualifies her as an independent contractor with respect to IRS guidelines.

3. No Established Policy and Procedures

As described, we failed to identify a defined policy or even informal/ad hoc rules or guidelines regarding the retention of Third Party Service Providers other than the May 2002 Board resolution that authorized Mr. Fuelberg to "employ such additional attorneys from time to time as he deems necessary…"[579] The retention of outside consultants appears to have been conducted at Mr. Fuelberg's discretion.

While certain Third Party Service Providers were retained through approval of the Board, the Board meeting minutes provide scant details as to what, if any, discussions occurred regarding their respective retention. In addition, the Board minutes are silent as to whether any discussion was held regarding the anticipated compensation method or payment amount, such as the guaranteed monthly retainer that appeared to have been most often used by Mr. Fuelberg. In addition, while certain Directors recalled the retention of several of the Third Party Service Providers, they were surprised that some of these consultants had been receiving monthly retainers from PEC for many years.

4. Board Lack of Knowledge/Approval of Compensation/Contract Term

Interviews with Directors who served on PEC's Board at the time of the retention of certain Third Party Service Providers disclosed their concerns with not adequately being informed of the amount of compensation paid to the individuals, as well as the former General Manager's failure to keep the Board apprised of the length of the retention. In many instances, the PEC Board minutes reflect no information related to the amount of compensation or length of the retention agreement.

[579] Pedernales Electric Cooperative, Inc. Board Resolution, May 20, 2002.

In addition, the Directors noted that they were not regularly informed by Mr. Fuelberg regarding which Third Party Service Providers were providing services to PEC. The Directors also expressed concerns that they were unaware of the services the Third Party Service Providers were providing. Payments to the Third Party Service Providers were, however, included in the long lists of checks paid the previous month that were traditionally part of the Board package. Generally, the retention of consultants and the details of their engagement are matters within the scope of management's authority, and are not an issue over which Directors should exercise supervisory control. However, the inconsistent nature of management communications to the PEC Board regarding the number, length, purpose, and cost of consultant arrangements during the period under investigation is disturbing, particularly because many of the amounts were substantial, and the value of at least some of those engagements to PEC appears to be questionable.

5. No Formal Contracts/Agreements

As described, there were typically no formal contracts or agreements for Third Party Service Providers that outlined the scope of services, amount of compensation or the term of the agreements with the Third Party Service Providers.

6. Limited Audit/Review Process

As a result of the lack of contracts, agreements, formal Board resolutions, or management policies providing sufficient detail related to the scope of services, amount of compensation, or the term of the engagement, PEC personnel in the Finance and Legal departments were unable to effectively monitor third-party contract deliverables, costs, and terms to ensure that costs incurred were appropriate. In addition, the PEC Finance Manager and his department had limited or no knowledge nor access to information related to these engagements, other than letters or memoranda sent by Mr. Fuelberg instructing that payments be made.

D. Recommendations

PEC has already taken significant steps to address the questions surrounding the retention and compensation arrangements for the identified Third Party Service Providers. As described, the General Manager has terminated the arrangement with a number of the Third Party Service Providers and is currently reviewing the agreements of others.

Adopt New Board Policy

- Pursuant to allegations and concerns raised regarding the retention of Third Party Service Providers, at the direction of the new PEC General Manager, PEC has adopted a new *Authority and Responsibilities Policy* applicable to both PEC employees and the Board.[580] The policy establishes specific guidelines as to when, and for whom, prior authorization is required for entering into a consulting contract with Third Party Service Providers. The policy requires the General Manager to receive Board approval in advance for consulting

[580] Authority and Responsibilities Policy, Pedernales Electric Cooperative, Inc., Board adopted: November 17, 2008.

contracts in excess of $1 million or for a term greater than two years. Navigant Consulting considers the new PEC policy to be appropriate.

Formalize Contract and Agreement Process and Reporting Function

- PEC's ad hoc process lacked the rigor and objectivity of having an established internal policy and procedure regarding Third Party Service Provider retention selection, retention requirements, authorization requirements, and compensation guidelines, as well as a mechanism for periodic performance evaluation for longer-term agreements. In addition, PEC failed, in many cases, to require contracts or agreements setting out the terms, conditions, and anticipated services to be provided. Also noteworthy is the lack of invoices or any kind of documentation to support the payments PEC made to a number of the Third Party Service Providers. It is recommended that PEC establish clear policies and procedures regarding the retention of various outside consultants and Third Party Service Providers including minimum requirements for contracts and agreements, invoicing and periodic, or at least annual, disclosure of agreements to the Board. At a minimum, it is recommended that the Board have an opportunity to periodically evaluate whether such agreements are in the best interest of the Cooperative and its members.

Establish Audit and Review Process

- PEC lacked a formal audit and review process of the arrangements with the Third Party Service providers. The Finance department was not provided with sufficient information and supporting documentation to evaluate the arrangements and was relegated by Mr. Fuelberg to essentially a payment processing function. It is recommended that PEC establish policies and procedures for contracts to be audited and reviewed by the Finance and Legal Services Departments to ensure that fees incurred are appropriate and that invoices include appropriate level of detail to verify the services provided and to justify payment.

XXIV. Construction Contractor and Material Supplier Contracts

A. Background

During the investigation, as well as throughout the class action lawsuit, questions were raised regarding certain construction contractor and material supplier contracts maintained by the Cooperative including allegations of "bid-rigging" and "no-bid" contracts.

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and evaluating the Cooperative's construction contractor and material supplier contracting process. Inherent to our efforts was the review and evaluation of the Cooperative's construction contractors and material suppliers, including a review of the contract procurement process, awarded contracts, vendor agreements and other financial transactions.

More specifically, the scope of our work included the following:

- Identifying and reviewing policies and procedures related to the construction contractor and material supplier contracting process including contract procurement and purchasing policies and procedures.

- Identifying the Cooperative's top 50 vendors including construction contractors and material suppliers based on total payments during the period October 2001 - 2007.

- Identifying and reviewing information related to construction contractors and material suppliers, including but not limited to, contracts, correspondence, and financial information.

- Identifying and reviewing Board policies, Board resolutions and operating procedures related to purchasing policies and procedures, construction contractors and material suppliers.

- Reviewing and analyzing information provided by the purchasing function related to the purchase of electric poles during the period October 2001 – 2007.

- Reviewing and analyzing information provided by the purchasing function related to the purchase of overhead and underground conductor and overhead and padmount transformers during the period October 2001 – 2007.

- Identifying and reviewing quote sheets and other documentation related to the purchasing function's bid process for certain materials.

- Identifying and reviewing an additional sample of quote sheets and other documentation related to the purchasing function's bid process during period October 2001 – 2007.

- Conducting interviews and discussions with Cooperative personnel regarding the construction contractor and material supplier contracting process.

2. Limitations on Work Performed

Based on a review of hard copy and electronic information and interviews with PEC personnel, we identified that detailed information related to the contracting process for construction contractors and material suppliers would be limited prior to October 2001 due to the financial system conversion from a prior vendor system to JD Edwards. As a result, our analysis focused on the period October 2001 – 2007. It is also our understanding that PEC does not enter into formal contracts with material suppliers for certain types of transactions including informal purchase arrangements and blanket purchase orders. As a result, specific contract or agreement terms and conditions including unit prices and quantities were unavailable in many instances. In addition, during our analysis we were only able to compare the purchases of certain materials on a yearly basis. As a result, material price comparisons and averages could include prices from January and December which may reflect significantly different prices due to market price fluctuations. However, we do not believe that this timing factor significantly impacted our analysis.

3. Purchasing Policy & Procedures

1998 Purchasing Procedures

Mr. Fuelberg established a purchasing procedure in January 1998 that provided authority to the Department and District managers for invoice approval. Specifically, the procedure allowed for "all invoices for services with no dollar limit (contract labor/material, tree trimming, janitorial, engineering, consulting, training, printing and legal), merchandise or material inventory non-stocked items less than $1,500, travel, maintenance agreements, membership fees, insurance, taxes, vehicle registrations/tags, minor repair orders, employee benefits, garnishments, subscriptions, postage, utility payments, donations, damage claims, and advertising" to "be reviewed by the appropriate Department manager, approved, coded, and sent to Accounting for payment."[581] A report of the invoices was to be prepared and provided to Mr. Fuelberg. Prior to the implementation of this policy, confirmation purchase orders were required for processing items over $250 or for invoices over $1,500 for which the material or service had already been received.[582]

2000 Board Purchasing Policy

The Board adopted a "Purchasing Policy" in October 2000 stating that "bids be taken to the maximum extent possible" and that the Board shall by annual resolution "set an amount and/or conditions for purchases, which shall not require a bid process."[583] The policy also authorized the General Manager to "establish procedures and reporting requirements for non-bid items" and

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[581] Letter from Bennie Fuelberg to All Managers, Re: Confirmation Requisition/Purchase Order Procedure, January 13, 1998.

[582] Letter from Bennie Fuelberg to All Managers, Re: Confirmation Requisition/Purchase Order Procedure, January 13, 1998.

[583] Pedernales Electric Cooperative, Inc., Board of Directors Purchasing Policy, November 1, 2000.

required the General Manager to "prepare procedures for the implementation of this policy."[584] A "Purchasing Limit" policy was also adopted by the Board in October 2000 which "set an annual limit of $2,500… for purchases which shall not require a bid process."[585] We did not identify subsequent Board resolutions addressing "an amount and/or conditions" for purchases.

2003 Purchasing Procedure

Mr. Fuelberg further clarified the purchasing procedure in September 2003 by requiring "a manager's signature before payment is authorized" for "all invoices which exceed $2,000 per month or $25,000 per year."[586] Mr. Fuelberg believed that the manager's signature indicated that the manager had "taken steps to ensure the invoices accurately reflect goods and/or services received by the Cooperative and necessary to meet its obligations to the membership."[587] The procedure also indicated that "invoices not meeting the above minimums can be paid with supervisor approvals" however, the manager "should ensure they meet the same requirements."[588]

Current Purchasing Function Policy and Procedures

The purchasing function solicits quotes/bids from at least two suppliers upon receipt of a requisition order from a Department or individual.[589] The purchasing function then selects a winning supplier according to the lowest bid, quality, lead time, or managerial instruction and then creates a materials purchase order or blanket order.[590,591]

The bids are solicited by way of written quotations from approved supplier sources for both one-time purchase orders and blanket orders. The number of bidders solicited depends on the nature and availability of the item or items to be purchased. However, competitive bidding was not required or solicited under the following circumstances: (1) when only one known source of supply is available, (2) emergency material is picked up by field personnel for immediate use and requirements for repair parts, (3) additions are made to existing equipment to match other existing equipment.[592]

Blanket purchase orders were utilized by PEC and were established as one-year contracts. If blanket orders had high usage and the estimated quantity allotted for the length of contract was insufficient and that limit was used in a shorter time span, the supplier was given the opportunity to increase the quantity at the original blanket price. If the supplier could not maintain the original price, the purchasing function would re-bid the blanket purchase order. If a blanket agreement reached the

[584] Pedernales Electric Cooperative, Inc., Board of Directors Purchasing Policy, November 1, 2000.
[585] Pedernales Electric Cooperative, Inc., Board of Directors Purchasing Policy, November 1, 2000.
[586] Letter from Bennie Fuelberg to All Managers, Re: Invoice Approval, September 26, 2003
[587] Letter from Bennie Fuelberg to All Managers, Re: Invoice Approval, September 26, 2003.
[588] Letter from Bennie Fuelberg to All Managers, Re: Invoice Approval, September 26, 2003.
[589] The purchasing Department solicits quotes/bids in instances where the purchasing Department is involved in the purchasing process.
[590] Document titled Current Methods Utilized by Purchasing Department.
[591] It is our understanding that "managerial instruction" relates to a manager instructing the Purchasing Department to select a bid based on quality, lead time or brand.
[592] Document titled Current Methods Utilized by Purchasing Department.

end of its term and quantities were left on the blanket agreement, the contract cancel date would be extended until the quantities were used.[593]

4. Background

The purchasing function is a group in the Project Maintenance Department. The purchasing function is typically not involved in the procurement process for construction contractors, as these contracts and agreements are typically negotiated by the Department or District manager. However, it is our understanding that a majority of the materials purchased including electric poles, transformers, and conductor is acquired through the purchasing function's procurement process.

The Cooperative also engages contractors to provide a variety of services including, but not limited to, substation construction and maintenance, tree trimming and mowing, distribution and transmission line construction, and other miscellaneous construction projects (e.g., parking lot paving, roof repair/replacement). A summary of the total payments to the top ten construction contractors during the period October 2001 – 2007 is included below.

Summary of Construction Contractors - Top 10 by Dollars (October 2001 - 2007)

Contractor	2001	2002	2003	2004	2005	2006	2007	Total
Red Simpson, Inc. / Pike Electric, Inc.	$2,546,855	$10,227,114	$7,246,511	$8,474,502	$7,973,028	$10,877,994	$7,929,184	$55,275,187
LCRA - Construction	1,956,806	6,380,328	3,314,018	4,989,336	3,772,138	1,441,422	1,451,700	23,305,749
Flowers Construction Company, Inc.	42,501	467,256	1,161,739	1,658,271	1,880,958	3,796,277	3,818,448	12,825,450
National Tree Expert Company, Inc.	408,844	1,368,406	1,417,343	1,572,285	1,959,459	1,668,853	1,020,877	9,416,066
The Davey Tree Surgery Company	203,414	759,508	868,601	1,101,112	1,570,558	1,935,074	2,473,193	8,911,460
Dig Tech, Inc.	283,985	1,146,290	623,481	912,132	1,361,913	1,696,287	1,636,046	7,660,134
Lambda Construction, Ltd.	-	-	-	-	323,798	1,022,901	4,590,647	5,937,347
C E S A Contractors, Inc.	377,227	1,126,283	1,143,129	1,221,511	283,574	-	-	4,151,725
Eckhardt Elect Const, Inc.	114,914	710,660	846,206	655,856	750,974	687,009	722,721	4,488,341
Brath, Inc.	-	-	-	-	-	363,797	3,119,839	3,483,636
Total	**$5,934,545**	**$22,185,846**	**$16,621,029**	**$20,585,005**	**$19,876,402**	**$23,489,615**	**$26,762,653**	**$135,455,095**

The Cooperative also purchases a variety of materials from vendors and suppliers including but not limited to wire, poles, and transformers. A summary of the total payments to the top ten material suppliers during the period October 2001 – 2007 is included below.

Summary of Material Suppliers - Top 10 by Dollars (October 2001 - 2007)

Supplier	2001	2002	2003	2004	2005	2006	2007	Total
TEC Utility Supply & Service	$6,622	$728,519	$4,059,019	$8,460,713	$17,879,315	$25,503,946	$26,947,120	$83,585,254
K B S Electrical Distributors	2,502,793	4,562,895	4,246,569	4,044,203	4,457,021	3,222,561	4,289,349	27,325,391
Techline, Ltd.	2,497,374	3,128,964	2,140,989	3,027,339	2,063,116	3,471,227	4,160,364	20,489,375
TEC - Pole Division	817,396	2,960,071	2,698,598	2,678,717	2,840,596	3,057,107	3,938,151	18,990,636
Wesco Distribution, Inc.	1,695,590	4,435,338	2,418,052	2,249,900	1,321,206	1,521,537	3,507,189	17,148,813
HD Supply, Inc.	-	-	838,937	3,444,407	3,111,580	1,064,508	4,728,224	13,187,656
Priester-Mell & Nicholson, Inc.	536,785	1,800,034	2,288,838	2,056,922	627,149	637,181	901,549	8,848,458
Priester Supply Company, Inc.	1,105,925	2,682,302	1,433,340	1,912,806	1,193,579	301,354	-	8,629,305
Cooper Power Systems	210,105	601,606	484,983	709,654	475,775	1,440,035	2,257,883	6,180,042
Altec Industries, Inc.	296,940	562,194	513,103	615,353	1,351,085	700,041	1,649,711	5,688,427
Total	**$9,669,530**	**$21,461,923**	**$21,122,428**	**$29,200,015**	**$35,320,423**	**$40,919,498**	**$52,379,541**	**$210,073,357**

[593] Document titled Current Methods Utilized by Purchasing Department.

5. Overview of Contracting Process for Construction Projects

PEC typically entered into contracts with tree trimming and transmission and distributions line construction contractors that outlined the terms of the contract and the hourly rate for services or the unit price for constructing certain items. It is our understanding that historically each District or Department would negotiate and enter into separate contracts with these contractors. As a result, contractors could potentially have had different terms based on the District or Department that negotiated the contract. However, in recent years, PEC centralized the contracting process at the Johnson City Headquarters and required that all contracts be approved by, and in some instances, negotiated by the Assistant General Manager. In addition, certain contracts or associated amendments were approved by the Board.[594] However, it is our understanding that PEC has not yet incorporated the use of standard terms and conditions across the contracts.

The majority of the substation maintenance and construction projects and other ad hoc construction projects were awarded through a bid process that was administered by the District or Department responsible for the project and ultimately approved by the former Assistant General Manager and former General Manager, and in some instances the Board.[595,596] The former General Manager would typically receive a memorandum or letter from the District or Department manager that outlined the bid process including a recommendation for the project award. Subsequent to the project award, a contract would typically be entered into between PEC and the contractor.

6. Overview of Contracting Process for Materials Suppliers

PEC did not enter into formal contracts or agreements with its material suppliers. As described, PEC's purchasing policy did not require the Cooperative to enter into long-term contracts or agreements with its material suppliers. Instead, PEC solicited bids by way of written quotations from approved supplier sources. However, as described, PEC was not required nor did it solicit bids on all of its material orders. Certain materials items were on a "blanket purchase order" that was bid out once a year. While there are no formal contracts or agreements with material suppliers, there were informal agreements or alliances with certain material suppliers. PEC participated in an informal agreement or alliance, and purchased the majority of certain materials, including poles, wires and transformers from one supplier, Texas Electric Cooperatives, Inc. ("TEC") during the period October 2001 - 2007.

7. Overview of Texas Electric Cooperatives, Inc.

TEC is a statewide organization dedicated to representing the interests of 65 electric distribution cooperatives and 9 generation and transmission cooperatives in Texas.[597] TEC's products and services include the following:

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594 Pedernales Electric Cooperative, Inc. Board of Directors meeting, November 19, 2007.
595 The Cooperative also worked with other entities to evaluate the proposals and bids.
596 Certain construction contracts for substation construction and maintenance were typically presented to the Board for approval.
597 TEC Website – About Us Section.

- Business Alliance Program
- Communications (Texas Co-op Power)
- Government Relations
- Cooperative Communications
- Loss Control Program
- Member Services
- Treating (Poles)
- Utility Supply & Service

Over the years, PEC has utilized the Utility Supply & Service, Treating, Member Services, Communications and Loss Control divisions of TEC. The Utility Supply & Service division of TEC ("US&S") "procures new utility equipment and provides supply chain management services" and the Treating (Pole) division operates a cooperatively owned utility pole production facility.[598] The Member Services division provides management and organizational development training (e.g., conferences and training seminars) and the Loss Control division provides safety and other training. The Communications division publishes the *Texas Co-op Power* magazine.[599]

TEC is governed by a Board of Directors consisting of representatives from the cooperatives it represents. Mr. Fuelberg was a Director of TEC during the period 2001 – 2003.[600]

It is our understanding that in or around May 2002, TEC was attempting to establish "supply alliances" with the cooperatives it represented.[601] As a result, TEC representatives were meeting with cooperatives, and in or around May 2002, TEC was informed that "the Pedernales Electric Cooperative's Board of Directors authorized their General Manager, Bennie Fuelberg, to enter into negotiations to purchase all materials and supplies from US&S."[602]

8. Purchases from Texas Electric Cooperatives, Inc.

In May 2002, the Board authorized the Cooperative to "purchase materials from Texas Electric Cooperative US&S whenever available, without going through the bid process."[603] Subsequent to the Board meeting and resolution, Mr. Fuelberg instructed the purchasing Department to "purchase construction materials from US&S without bidding in a manner similar to the way we purchase poles from the pole plant. If our specified materials are available through US&S in a timely fashion, we will purchase them from them. If at any time their prices, availability or delivery schedules become a problem, we will acquire materials from other vendors. Please notify me when this occurs. Keep me informed of the progress of this process."[604]

In February 2005, the Board resolved "that the Cooperative will purchase all transformers, wire, and cable from TEC US&S for at least six months."[605]

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[598] TEC Website.
[599] TEC Website.
[600] TEC Directory and email from TEC.
[601] Fax from Wilburn Neyland (TEC) to Will Martin and Hubert D'Spain dated June 10, 2002.
[602] Fax from Wilburn Neyland (TEC) to Will Martin and Hubert D'Spain dated June 10, 2002.
[603] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.
[604] May 28, 2002 Letter from Bennie Fuelberg to Mike Elder Re: Purchasing of Materials.
[605] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., February 21, 2005.

9. Summary of Payments to TEC

PEC purchased materials (e.g., poles, wire, transformers, etc.) from TEC totaling over $100 million during the period October 2001 – 2007. In addition, PEC made additional payments of over $7.0 million for other services including transformer repair, administrative services and costs associated with the publishing of Texas Co-Op Power. A summary of the payments to TEC is included below:

Summary of Payments to Texas Electric Cooperatives, Inc. (October 2001 - 2007)								
Description	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**
TEC Utility Supply & Service	$1,575	$722,628	$4,047,814	$8,467,213	$17,992,529	$25,454,071	$26,821,808	$83,507,638
Pole Division	377,592	2,730,510	2,723,984	2,687,260	2,840,362	3,063,474	3,932,902	18,356,083
Print Shop	40,864	796,130	624,890	547,398	537,581	572,009	710,935	3,829,806
Transformer Repair Division	51,952	252,264	338,247	386,298	326,790	237,592	348,110	1,941,253
Administrative Services Division	164	169,330	164,930	143,929	188,066	190,116	177,439	1,033,974
Other	9,328	18,851	17,696	98,159	21,935	23,560	62,131	251,660
Total	**$481,474**	**$4,689,712**	**$7,917,563**	**$12,330,256**	**$21,907,262**	**$29,540,822**	**$32,053,325**	**$108,920,414**

10. Poles Purchases from TEC

PEC requires multiple pole types for its business operations. The pole types differ by height and width. PEC purchased over 70,000 poles across eight different pole types during the period October 2001 – 2007. A summary of the pole types and quantities purchased is included below.

Summary of Pole Types and Quantities Purchased (October 2001 - 2007)								
Pole Type	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**
Pole 45 CL3	9	346	3,199	7,400	8,663	7,272	5,824	32,713
Pole 40 CL4	1,804	5,941	3,301	-	2	-	-	11,048
Pole 45 CL4	327	1,497	1,216	2,092	878	2,167	2,289	10,466
Pole 35 CL4	-	-	386	2,299	1,996	2,810	1,956	9,447
Pole 40 CL5	834	4,359	1,853	-	-	-	-	7,046
Pole 40 CL2	-	4	116	-	-	-	-	120
Pole 40 CL3	-	76	-	-	-	-	-	76
Pole 45 CL5	1	-	-	-	-	-	-	1
Total	**2,975**	**12,223**	**10,071**	**11,791**	**11,539**	**12,249**	**10,069**	**70,917**

As described, PEC purchased over 85% of its poles from the Treating division of TEC. The majority of the remaining poles (over 12%) were purchased from two other suppliers (Thomasson Lumber Company and Colfax Treating Company). A summary of the number of poles purchased from each supplier during the period October 2001 – 2007 is included below.

Summary of Pole Purchases by Supplier (October 2001 - 2007)								
Supplier	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Total**
TEC Pole Division	2,777	11,771	9,724	10,120	8,837	7,703	9,486	60,418
Thomasson Lumber Company	-	-	178	786	915	2,452	391	4,722
Colfax Treating Company	-	-	-	885	1,181	2,044	192	4,302
Koppers Industries, Inc.	198	452	169	-	-	-	-	819
North Pacific Group	-	-	-	-	606	-	-	606
Conroe Wood Products, Inc.	-	-	-	-	-	43	-	43
Lone Star Infrastructure	-	-	-	-	-	7	-	7
Total	**2,975**	**12,223**	**10,071**	**11,791**	**11,539**	**12,249**	**10,069**	**70,917**

PEC incurred costs of $17,014,152 related to the purchase of the 70,917 poles. We performed a detailed analysis of the four most frequently purchased pole types (i.e., Pole 45 CL3, Pole 40 LC4, Pole 45 CL4 and Pole 35 CL4) which totaled 63,674 or 90% of the total poles purchased. PEC purchased 53,313 poles from TEC and 10,361 poles from other suppliers out of the 63,674. The analysis included calculating the average yearly pole cost for each pole type purchased from TEC and the other suppliers. Based on our analysis, it appears that TEC's average pole cost per year was typically lower than other material suppliers for each pole type.[606]

11. Material Purchases from TEC

PEC purchased materials including wire, conductor, transformers, and other materials from TEC US&S beginning in 2002 totaling over $83 million. The May 2002 PEC Board resolution authorized the Cooperative to "purchase materials from Texas Electric Cooperative US&S whenever available, without going through the bid process."[607] However, the US&S did not offer all of the materials required by PEC. As a result, PEC purchased a majority of their materials from TEC US&S but continued to purchase materials from other material suppliers as well.

It is our understanding that the bulk of the material purchases by the Cooperative relate to the construction of overhead and underground lines including conductor (e.g., wire) and transformers. As a result, we focused our review of the materials purchased from TEC and other suppliers related to these items during the period October 2001 – 2007. This review encompassed the evaluation of approximately 4,516 transactions related to the purchase of 51 types of conductor totaling over $54 million and approximately 2,545 transactions related to the purchase of 75 types of transformers totaling over $46 million. A summary of PEC's purchases of overhead and underground conductor and overhead and padmount transformers during the period October 2001 – 2007 is included below.

Summary of Purchases of Conductors and Transformers (October 2001 - 2007)

Description	2001	2002	2003	2004	2005	2006	2007	Total
Conductors	$1,753,186	$4,009,287	$4,224,303	$7,736,318	$10,794,792	$13,323,376	$13,014,851	$54,856,113
Transformers	2,106,079	4,697,880	4,348,197	5,024,540	6,788,285	11,959,733	11,859,242	46,783,956
Total	**$3,859,265**	**$8,707,167**	**$8,572,500**	**$12,760,858**	**$17,583,078**	**$25,283,109**	**$24,874,093**	**$101,640,069**

Over 77% ($42,495,856) of PEC's purchases of overhead and underground conductor and 61% ($28,695,267) of the purchases of overhead and padmount transformers were from TEC US&S. While a detailed analysis of the circumstances (e.g., quality and lead time) and costs associated with all materials purchased by the Cooperative is beyond the scope of this investigation, we did perform an analysis of the transactions related to the five most frequently purchased conductor and transformer types during the period October 2001 – 2007, which represent 78% of the total conductor and 67% of the total transformers purchased by PEC.

[606] We identified seven poles purchased in two separate transactions where the average pole cost per year was lower at a supplier other than TEC. It is our understanding that these poles were purchased from a construction contractor that had an excess supply of poles after completing a construction project. As a result, it is our understanding that the purchase price did not reflect a market price from a material supplier.

[607] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.

Based on the analysis performed, it appears that TEC US&S's average unit cost per year for certain conductor and transformer purchases was typically not lower than other material suppliers during the period October 2001 – 2004 and that PEC has purchased virtually all conductor during the period 2005 – 2007 and all transformers during the period 2006 - 2007 from TEC US&S. As described, it is our understanding that PEC currently has an informal "cost plus" arrangement with TEC US&S, which requires TEC US&S to warehouse and manage the supply of the materials, to purchase conductor and transformers. In addition, as described, it is our understanding that PEC enters into blanket purchase orders with TEC that are re-bid each year. As a result, we did not compare the average unit cost for the conductor and transformers to other suppliers during the period 2005 – 2007.

12. Bid Practices for TEC Material Purchases

As described, the Cooperative began purchasing items from TEC US&S subsequent to a Board resolution authorizing the Cooperative to "purchase materials from Texas Electric Cooperative US&S whenever available, without going through the bid process."[608] However, the purchasing Department continued to solicit bids from multiple suppliers including TEC. We identified instances during the period 2003 – 2004 where the purchasing Department would receive bids from multiple suppliers including US&S, identify the low bid, and then contact TEC to see if TEC could match the low bid if they were not already the low bidder. If TEC was able to match the low bid, TEC would be awarded the order.[609]

13. TEC Patronage Dividends and Capital Certificates

As a cooperative, TEC returns patronage dividends and patronage capital certificates to its members each year based on the amount of payments to TEC from PEC and the prior year margins for each of TEC's divisions. Twenty percent (20%) of the margin from the prior year is paid in the form of a patronage dividend and the remaining 80% is issued in the form of a patronage capital certificate. As a result, PEC benefits through the receipt of patronage dividends and capital certificates by purchasing poles, materials and other services from TEC. PEC has received the following patronage dividends and patronage capital certificates from TEC for the period 2002 – 2007:

Summary of Patronage Dividends and Capital Certificates from TEC (2002 - 2007)

Patronage	2002	2003	2004	2005	2006	2007	Total
Dividends	$32,910	$28,785	$10,886	$13,226	$303,425	$297,734	$686,966
Capital Certificates	131,640	129,240	43,545	52,903	805,863	531,683	1,694,874
Total	**$164,550**	**$158,025**	**$54,431**	**$66,129**	**$1,109,288**	**$829,417**	**$2,381,839**

608 Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., May 20, 2002.

609 We also identified instances in which TEC Utility Supply & Service would win the bid but not be the low bidder. However, the difference in the TEC Utility Supply & Service bid and the other supplier's bid were typically minimal.

B. Observations and Findings

1. Limited Formal Contracts/Agreements

As described, PEC typically enters into formal contracts and agreements with construction contractors that outline the scope of services, costs and terms of the contracts. However, PEC does not have formal agreements or contracts with its material suppliers. We also have not identified a written contract or agreement with TEC for the "cost plus" arrangement related to the purchase of wire and transformers. No documentation was identified that established the term of the agreement or the markup for materials subject to the informal "cost plus" arrangement.

2. Limited Policies & Procedures

The Board policy adopted in October 2000 simply stated that "bids be taken to the maximum extent possible" and that the General Manager was required to "prepare procedures for the implementation of this policy."[610] Despite this directive, we were unable to identify defined procedures other than the informal/ad hoc rules or guidelines established by Mr. Fuelberg. While these informal guidelines established pre-determined spending limits, expense levels or ranges, and expenditure authorization or approval requirements, the authority was delegated to the managers of the Departments and District offices. Mr. Fuelberg essentially delegated authority to each of the Department and District managers to enter into construction contracts and incur other expenses on behalf of the cooperative without utilizing the Purchasing Department.

While certain purchasing arrangements (i.e., TEC) were approved through the Board, the Board meeting minutes do not provide details as to what, if any, discussions occurred regarding the respective agreements. In addition, the Board minutes were silent as to whether any discussion was held regarding the anticipated contract term or payment amounts, implying that the Board and essentially delegated authority to Mr. Fuelberg to establish procedures at his discretion.

The Purchasing Department also had its own policies and procedures related to the purchasing of materials. However, as described, these policies and procedures focused primarily on the mechanics of soliciting bids and quotes and did not address the requirements (e.g., cost, item type, etc.) for different types of agreements (e.g., "cost plus" arrangements and blanket or single purchase orders).

3. Limited Purchasing Function

The investigation found evidence of certain large expenditures including entering into construction contracts that properly should have been handled through the purchasing function in order to ensure that proper controls were followed and that reasonable and consistent prices were obtained for the items acquired. Large expenses were identified that in many respects should have been subject to a more formal procurement process involving the purchasing function in order to ensure that prices were reasonable and consistent and that proper approvals were obtained, as well as that materials

[610] Pedernales Electric Cooperative, Inc., Board of Directors Purchasing Policy, November 1, 2001.

received were consistent with the terms of the respective purchase order. The purchasing function was essentially relegated to a procurement function for materials.

4. Construction Contracts Awarded to the Low Bidder

Construction contracts that were put up for bid appear generally to have been awarded to the low bidder. We did identify instances where the construction contractor with the low bid was not awarded the contract. However, there was typically a documented reason for the low bid not being selected including prior experience with vendor, bad references, poor quality material, or timing. We also identified instances in which the LCRA was not awarded certain construction and maintenance contracts even though it was qualified and was the low bidder. We were told that the former General Manager instructed PEC personnel during different periods of time to not award any contracts for construction or maintenance projects to LCRA. Throughout the course of the investigation we did not identify other potential areas of concern in the construction contracting bid process other than the questions regarding the bid process with LCRA and the lack of formal policies and procedures described above.

5. Material Purchases Potentially Not at Low Cost

While we have been unable to compare the average unit cost for the conductor and transformers to other suppliers during the period 2005 – 2007, it appears that TEC US&S's average unit cost for the five most frequently purchased conductor and transformers was higher than other suppliers during the period October 2001 – 2005. In addition, as described, we have been unable to determine if PEC received the lowest cost from TEC US&S for conductor and transformer purchases during the period 2005 – 2007 as a result of the informal "cost plus" arrangement. However, it should be noted that TEC was responsible, through the "cost plus" arrangement, for warehousing and managing the inventory. Throughout the course of the investigation we did not identify potential areas of concern in the material supplier procurement process other than the purchasing practices with TEC and the lack of formal policies and procedures described above.

6. Conflict Considerations and the Benefits of TEC Purchases

Mr. Fuelberg's position as a Director of TEC during the period 2001 – 2003 might raise questions about the potential for a conflict of interest. However, TEC is not a conventional third-party vendor or supplier, given its status as the statewide trade organization for cooperatives in Texas, and as a non-profit cooperative in which PEC was and is a member.

TEC represents the interests of a number of electric distribution cooperatives and generation and transmission cooperatives in Texas.[611] PEC's use of TEC as its primary supplier of poles and other materials not only benefits PEC but also benefits other cooperatives throughout Texas. TEC is able to offer low prices on poles and other materials as a result of its ability to purchase large quantities of materials directly from the distributors. As a result, the more materials PEC purchases from TEC, the lower the price PEC and other cooperatives receive from TEC. In addition, PEC received patronage

[611] TEC Website – About Us Section.

dividend and capital certificate payments from TEC during the period 2002 - 2007 totaling $ 2,381,839 which is not reflected in the price PEC paid per item.

The transactions with PEC must ultimately be evaluated on the basis of the economics of PEC's purchase arrangement with TEC as compared with alternate transactions that it could have entered into with for-profit commercial suppliers.

7. Summary

Other than the questions regarding PEC's bid practices with the LCRA and TEC and the Cooperative's limited policies and procedures, PEC personnel expressed no other knowledge or concerns regarding the procurement practices of the Cooperative, nor did we identify other instances of questionable practices in PEC's procurement process for materials or the retention of construction contractors.

C. Recommendations

New Policies and Procedures

- It is recommended that PEC establish more formalized policies and procedures for the Cooperative's purchasing function specifically related to the construction contractor and material supplier contracting process. The new policy should be evaluated in conjunction with certain business process improvement recommendations regarding the centralization of the contracting/purchasing function into one Department, with specific guidelines to ensure that proper controls are followed and that reasonable and consistent prices are obtained for the items acquired/services received.

Formal Agreements and Contracts

- PEC typically enters into formal contracts and agreements with the construction contractors that outline the scope of services, costs and terms of the contracts. However, PEC does not have formal agreements or contracts with its material suppliers. It is recommended that PEC formalize its relationship with material suppliers specifically related to certain blanket purchase orders and "cost plus" arrangements.

Informal Arrangements and Agreements

- As described, PEC purchases a majority of its materials from TEC US&S. It is recommended that PEC review the informal alliance or arrangement with TEC including evaluating other alternate material suppliers at least on a periodic basis to ensure PEC continues to receive low cost quality materials.

XXV. Land and Building Purchases

A. Background

With regard to the questions raised around related or affiliated party transactions and the potential for conflicts of interest, we also evaluated PEC's purchases of land and buildings during the period under investigation. PEC purchases land and buildings for various purposes including for electricity transmission (i.e., easements) and distribution (i.e., substations) and for general purposes (i.e., business office).

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and evaluating the land and buildings purchased by PEC during the period 1998 – 2007. Inherent to our efforts was the review and evaluation of the information retained by the Cooperative related to the land and building purchases and information from outside sources. However, based on information identified through the investigation including the potential that one or more purchases may have been involved with PEC related or affiliated parties, we expanded our scope to include additional land and building purchases made by PEC prior to 1998.

More specifically, the scope of our work included the following:

- Identifying land and building purchases during the period 1998 – 2007 and reviewing detailed supporting information including, but not limited to, closing documents, appraisals, and deeds.
- Identifying Board resolutions related to the purchase of land and buildings during the period 1998 – 2007.
- Identifying and reviewing all additional land and building purchases recorded in the Cooperative's JD Edwards Fixed Asset Database (fixed asset database).[612]
- Identifying and preparing a summary of all land and building purchases recorded in the fixed asset database with a purchase price greater than $15,000, which we identified for additional review.
- Requesting and reviewing additional detailed supporting information including, but not limited to, deeds for certain land and building purchases identified for additional review.

[612] Includes all land and building purchases made by the Cooperative with the exception of land and buildings that were purchased and sold prior to October 2001.

- Where available, reviewing county appraisal district information, deeds and other ownership related information to identify the seller and current, as well as historical, appraisal values.

- Reviewing and evaluating information for land and building purchases to identify any potential conflicts of interest or related party transactions, as well as the Cooperative's purpose for purchasing the land and/or building.

- Conducting interviews and discussions with current and former Cooperative personnel regarding land and building purchases identified for additional review.

2. Limitations on Work Performed

As described, the scope of work was initially limited to the land and building purchases during the period 1998 – 2007. However, based on information identified throughout the course of the investigation, the scope was expanded to include all land and building purchases by PEC currently included in PEC's fixed asset database. However, land and buildings that were purchased and sold prior to 2001 are no longer included in PEC's fixed asset database.[613] In addition, the data included in PEC's fixed asset database for certain land and building purchases prior to 1990 was limited due to the Cooperative's record retention and tracking practices at that time.

Other information (e.g., purchase price and acquisition date) included in PEC's fixed asset database does not represent the actual date of sale or the "cost" of the land and building. Closing costs, attorneys' fees and improvements are included in the "cost" and the acquisition date represents the day PEC put the asset "into service." In addition, information and records available from a majority of the county appraisal districts was limited prior to 1992. While these limitations did not restrict our ability to complete the evaluation, it made the identification of certain land and building purchases difficult especially with regard to land and building purchases prior to 1992.

Our analysis focused primarily on general plant land and building purchases including land and buildings purchased for business offices and service centers. Transmission and distribution plant (e.g., right of way easements and substations) land and building purchases must meet certain engineering requirements (e.g., location, grade of land, access to electric lines) whereas land and building purchases do not. As a result, transmission and distribution related land and building purchases were not evaluated in detail prior to 1998.

3. Background

The Cooperative purchases land and buildings for several reasons including the construction of distribution and transmission substations, right of way ("ROW") easements, and general non-operating functions (e.g., business office, service center). Land and building purchases are tracked in PEC's fixed asset database by the plant accounting function in the Finance Department. The fixed asset database includes all land purchases made by PEC with the exception of land that was

[613] It is our understanding that the Cooperative rarely sold land once it was purchased.

purchased and sold prior to October 2001 when PEC transitioned to their new accounting system (JD Edwards).

The fixed asset database included 110 land and building purchases booked to GL Acct. 103 - Transmission Plant Land & Land Rights (GL Acct. 103), GL Acct. 121 - Distribution Plant Land & Land Rights (GL Acct. 121) and GL Acct. 152 - General Plant Land & Land Rights (GL Acct. 152).[614] The number of land and building purchases identified in each general ledger account is summarized below.

Land and Building Purchases by GL Account			
GL Account	**Pre-1998**	**1998 - 2007**	**Total**
Acct. 103 - Transmission	22	5	27
Acct. 121 - Distribution	38	15	53
Acct. 152 - General	22	8	30
Total	**82**	**28**	**110**

<u>GL Acct. 103 - Transmission Plant Land & Land Rights</u>

Of the 27 land and building purchases included in GL Acct. 103, 23 were identified as ROW transmission easements based on the description in PEC's fixed asset database. Transmission easements are acquired from land owners to allow electricity to be delivered to the distribution substations. The ROW easements are recorded in PEC's fixed asset database in aggregate cost.

It is our understanding that the purchase price contained in the fixed asset database for the ROW easements was the aggregate amount paid to the land owners whose land was acquired through the easement, attorney fees and surveyor fees. In addition, as described, detailed information and records for ROW land and building purchases prior to October 2001 were not available for review. As a result, ROW easement purchases prior to October 2001 were not included in the land and building purchases for additional review. Two of the 23 ROW transmission easements were identified for additional review.

The purchase price for each of the remaining four land and building purchases in GL Acct. 103 were $15,000 or less which were not included for additional review.

<u>GL Acct. 121 - Distribution Plant Land & Land Rights</u>

Of the 53 land and building purchases included in GL Acct. 121, 51 were related to the purchase of land for the construction of substations. Substations are used by the Cooperative to aggregate electricity from the transmission lines for distribution to the Cooperative's members. The remaining two were related to Kimble Electric Cooperative but the purchase price was less than $15,000 each.

[614] Land & building purchases for the same property were tracked separately as a "land" and "building" item in the fixed asset database. For purposes of our analysis the land and building have been combined.

The purchase price was greater than $15,000 for 20 of the 51 substation-related purchases. Eleven of these 20 were purchased during the period 1998 – 2007 and were identified for additional review.

GL Acct. 152 - General Plant Land & Land Rights

As described, land and building purchases booked to GL Acct. 152 were for general plant purposes including business offices, service centers and a training center, among others. The land and building purchases were primarily related to land purchases for the construction of business offices and service centers. The indicated purpose of the thirty general plant land and building purchases are summarized below.

General Plant Land and Building Purchases by Purpose			
Purpose	**Pre-1998**	**1998 - 2007**	**Total**
District Service Center	14	-	14
District Business Office	4	4	8
Headquarters Related	3	1	4
Training Center	-	1	1
Other	1	2	3
Total	**22**	**8**	**30**

Of these 30, 25 were included for additional review, as the purchase price was greater than $15,000, including all eight of the land and building purchases during the period 1998 - 2007.

4. Summary of Land and Building Purchases Greater than $15,000

We identified 38 land and building purchases with a purchase price greater than $15,000 for additional review. As described, the 38 land and building purchases include two transmission, eleven distribution and 25 non-operating or general plant land and building purchases.

We requested documentation from PEC and researched publicly available information for the land and building purchases including, but not limited to, deeds, closing statements and county appraisal district information.[615] Where available, we identified information related to the acreage, current and historical appraisal values, current owner and the most recent seller for each of the land and building purchases.[616] In addition, we reviewed and evaluated the land and building purchases to identify any potential conflicts of interest or affiliated party transactions.

The results of our analysis are summarized in Exhibit 38.

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[615] Research included searches on the appraisal district websites for Hays, Travis, Williams, Blanco, Comal, Burnet, Llano and Kimble counties. Online appraisal information was not available for Burnet and Llano counties.

[616] The information available and format of the information varied from county to county. In addition, the purchase price was generally not available.

As a result of the analysis, we identified four land and building purchases involving potential related or affiliated parties. These land and building purchases are described in greater detail below.

5. Summary of Select Land and Building Purchases

Based on the analysis performed, we identified four land and building purchases that required further review. These purchases include the following:

Summary of Select Land Purchases from the Fixed Asset Database

Date Acquired	Desciption	Type of Plant	Acres	Acct.	Purchase Price	Appraised Value (2008)	Seller Name	County
1/27/1986	Dripping Springs Business Office	General	5.0	152	$ 93,177	$ 71,990	O.C. Harmon	Hays
5/31/1995	Wimberley Service Center	General	0.4	152	125,000	37,500	The Y, Ltd. (James H. McCrocklin)	Hays
12/31/2003	Miller Creek/Dripping Spr. ROW	Transmission		103	279,628		Various Easements (incl. R.B. Felps)	Hays/Blanco
8/17/2004	Training Center (River Palace)	General	4.0	152	900,000	1,127,580	Kuvet Family Trust	Blanco

Dripping Springs Business Office (Harmon Property)

The Cooperative purchased five acres of land in Dripping Springs from O.C. Harmon for $93,177 in 1986.[617] O.C. Harmon has served on the PEC Board since 1983 and is currently the Secretary and Treasurer of the Board. The five acres of land purchased from Mr. Harmon is located in Dripping Springs, Texas and is adjacent to the Dripping Springs business office (separated by a road). Approximately half of the land is currently being used as a service center and pole yard and the other half is vacant. However, it is our understanding that the land was not used for a period of time after the purchase.

The Board authorized Mr. Fuelberg "to purchase approximately five acres of land in Dripping Springs, Hays County, Texas, from O.C. Harmon for a consideration of $18,500 per acre" in August 1985.[618] No information was identified in the Board minutes that documented the reason for the purchase of the Harmon Property.

No appraisal or other documentation supporting the purchase price or business purpose of the land acquired from Mr. Harmon has been identified. While no information exists to support the purchase price, PEC did purchase an additional .8 acres of land (and a building) in Dripping Springs, Texas for $200,000 in 1998. The land and building purchased in 1998 was used to construct the Dripping Springs business office. The .8 acres was highway frontage property. Information from the Hays County Appraisal District indicates that the land purchased from O.C. Harmon has an appraised value of $71,990 as of 2008.[619]

In discussions with Mr. Harmon, he said he was approached by a third-party (unrelated to PEC) with regard to this land and that he did not realize PEC was the purchaser until the Board meeting where the reference resolution was passed. In addition, he said that the approach was unsolicited and that

[617] General Warranty Deed, January 27, 1986.
[618] Pedernales Electric Cooperative, Inc. Board Resolution, August 19, 1985.
[619] Hays County Appraisal District Information for Harmon Acres Subd, Lot 3, Acres 4.9993.

the land was not for sale at the time he was approached by the third-party. Mr. Harmon stated that he raised the potential conflict at the Board meeting and was assured by the former General Counsel, A.W. Moursund, that the circumstances surrounding the purchase were legal and should be of no concern to Mr. Harmon because the land was being purchased at fair market value. Mr. Harmon had no other information to add regarding the details of the purpose other than that PEC had an interest in locating a District office in Dripping Springs.

Wimberley Service Center (McCrocklin Property)

The Cooperative purchased .395 acres of land in Wimberley, Texas from The Y, Ltd. for $125,000 in May 1995.[620] The General Partner of The Y, Ltd. was James McCrocklin. Mr. McCrocklin has attended and participated in the PEC annual meeting and it appears that a relative of Mr. McCrocklin's was the chairman of the Nominating Committee on at least one occasion. Based on a review of available documentation and discussions with current PEC personnel, the land has not been used by PEC. It appears that the land was purchased for a proposed transmission line from Dripping Springs, Texas to Wimberley, Texas that was ultimately canceled.

No appraisal or other documentation supporting the purchase price or business purpose of the land acquired from Mr. McCrocklin has been identified. However, PEC purchased .158 acres of land adjacent to Mr. McCrocklin's land on the same day. The purchase price was approximately $90,000.

Miller Creek-Dripping Springs ROW Easement (Felps ROW Easement)

In researching available information, we identified that the Miller Creek-Dripping Springs ROW Easement appears to traverse land owned by R. B. Felps in Blanco County. Mr. Felps has been a Director since 1994 and is currently the President of the Board. It is our understanding that Mr. Felps may have received a payment for the easement. However, information and supporting documentation related to Mr. Felps' ROW easement has not been identified. As described, the amount paid to individual land owners for transmission easements was not documented prior to 2001. Instead, the payments were recorded in total.

The total cost associated with the Miller Creek-Dripping Springs ROW was approximately $359,051. We have been able to identify that approximately $279,628 was paid for the ROW after October 2001. This amount was accounted for in detail in PEC's fixed asset database and related to easement payments to land owners and attorney fees among other items. The average easement payment per land owner appears to have been approximately $2,000. The remaining total of approximately $80,000 in costs appears to relate to easements from the various land owners acquired prior to 2001 and potentially to additional attorney costs. We have been unable to determine the amount Mr. Felps may have received, if he received any compensation for the ROW easement.

[620] Settlement Statement, May 15, 1995.

River Palace

PEC purchased the River Palace for $900,000 from the Kuvet Family Trust (Rita Kuvet was listed as the Trustee) in August 2004. The River Palace was a large multi-functional building on the outskirts of Johnson City, Texas that had been a restaurant and a meeting hall over the years. PEC held its annual meeting at the River Palace from at least 1986 to 2007. The purchase and conversion of the River Palace into a training center was discussed as early as July 2001. Board meeting minutes in 2001 indicate that the sales price for the River Palace at the time was $480,000. However, PEC does not appear to have attempted to acquire the property that that time.[621] It is also our understanding that Mr. Fuelberg was approached by the previous owner of the River Palace in or around April 2002 and again by the Kuvet family in July 2003, regarding the sale of the River Palace to PEC.

The Board authorized Mr. Fuelberg "to purchase the Texas River Palace in Johnson City for the sum of $900,000" in July 2004.[622] As noted, the $900,000 purchase price was significantly higher than the referenced price of $480,000 for the property in 2001. After the purchase was completed, the River Palace was reconfigured and converted into the PEC Training Center. However, it is our understanding that only a portion of the River Palace is currently being used by the Cooperative for training purposes. Similar to the other land and building purchases, no appraisal or other documentation has been identified supporting the purchase price of the River Palace.

In addition, it appears that Shelton Coleman was the owner or operator of the River Palace prior to 2000 and that he sold the River Palace to another party prior to the Kuvet Family Trust acquiring the River Palace. It is our understanding that Shelton Coleman was the grandson of former Director M.C. Winters and may also have been affiliated with A.W. Moursund. We have not been able to identify the extent of Mr. Coleman's relationship with the Moursund family. However, based on available information, it does not appear that Mr. Coleman had any involvement in the subsequent sale by the Kuvet Family Trust to PEC.

C. Observations and Findings

1. Lack of Formal Policy and Procedures

We did not identify a formal policy or procedure related to the purchase of land and buildings. As a result, it appears that many of the land and building purchases were approved by the Board through a resolution authorizing Mr. Fuelberg to complete the purchase. The Board resolutions typically included the purchase price of the property. However, the resolutions did not normally outline the business purpose for the purchase, especially related to the general plant purchases.

2. Potential Related or Affiliated Party Transactions

We identified four land and building purchases to related or affiliated parties of the Cooperative including the Harmon Property, Felps ROW, McCrocklin Property and the River Palace. As

[621] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., July 16, 2001.
[622] Pedernales Electric Cooperative, Inc., Board Resolution, July 19, 2004.

described, the River Palace appears to have been owned by an individual with potential ties to the Cooperative prior to 2000. However, it appears that the entity (Kuvet Family Trust) that sold the River Palace to PEC was not related to the Cooperative.

While the Board was informed of, and ultimately authorized, the purchase of property from Mr. Harmon, it appears that the Board was not informed that PEC was purchasing land from Mr. Felps and Mr. McCrocklin. We did not identify any Board resolutions that disclosed the purchases from Mr. Felps and Mr. McCrocklin. All land and building purchases or any other type of transaction with a potential affiliated entity should be disclosed to the Board and potentially to outside parties.

3. Lack of Appraisals Supporting Purchase Price

As described, we did not identify appraisal or other documentation supporting the price for the land and building purchases. As a result, we have been unable to determine the reasonableness of the amounts paid for certain land and buildings.

4. Business Purpose for Land and Building Purchases

Due to the limited availability of information, we were unable to perform a detailed review of the purchasing process for each land and building purchase. However, we did identify two instances (Harmon Property and River Palace) where questions still exist regarding the purchase of the land and buildings. As described, it is our understanding that the Harmon Property was not utilized by PEC for a period of time and only approximately half of the property is currently being used as a service center and pole yard. In addition, it is our understanding that only a small portion of the River Palace is currently utilized as the training center.

D. Recommendations

Formal Policy and Procedures

- It is our understanding that PEC currently does not have a formal process and procedure for the purchase of land and buildings. It appears that Mr. Fuelberg would typically obtain authorization from the Board for land and building purchases. However, consistent with other items, the Board may not have received sufficient information to evaluate the purchase including the business purpose based on the information contained in the Board minutes. It is recommended that PEC implement policies and procedures that evaluate each general plant purchase including comparison to other available properties. That includes, among other items, obtaining appraisals for all property purchases and evaluating at least two alternatives to the property under consideration for purchase.

- PEC purchased land and buildings from individuals who were related parties of the Cooperative. It is recommended that PEC adopt policies and procedures that outline when and to whom disclosures are to be made when business transactions are conducted with related parties in which a potential conflict of interest may exist and what action should be taken by Directors or others affected by the transaction.

XXVI. Analysis of Other Accounts/Expenses

A. Background

Throughout the course of the class action litigation and ensuing criticisms from Cooperative members, the media and others, questions were raised regarding the overall expenses incurred by the Cooperative as well as whether certain expenditures were reasonable and necessary in the conduct of the Cooperative's business. The items questioned include expenses related to entertainment, meals, travel, advertising, the annual meeting and certain charitable donations. Many identified expenses were perceived to have been excessive and outside the realm of reasonable and necessary for the day-to-day management of the Cooperative.

B. Work Performed

1. Scope of Work

The scope of Navigant Consulting's work focused on identifying and evaluating general and administrative expenses incurred by the Cooperative during the period 1998 - 2007, primarily related to expenses incurred on behalf of or at the direction of Messrs. Fuelberg, Burnett and Dahmann, as well as other expenses incurred at the Cooperative's Johnson City Headquarters. Inherent to our efforts was the review and evaluation of the various policies and procedures that relate to the approval and payment of expenses and the determination of whether expenses were reasonable and necessary. Detailed analyses of expenses incurred by, or on behalf of, Senior Management and Directors, including credit card transactions and expense vouchers are addressed in previous sections of this Report.

More specifically, the scope of our work included the following:

- Identifying and evaluating current and historical expense payment policies and procedures.

- Identifying Board minutes and/or resolutions related to expense payment policies and procedures.

- Reviewing and analyzing the Cooperative's trial balances for the periods 2000 – 2007.

- Identifying and reviewing ratio analyses that address the Cooperative's administrative and general expense practices.

- Identifying general ledger accounts for additional review including the following:

    - GL Acct. 820 – A&G Office Supplies
    - GL Acct. 821 – A&G Contract Services
    - GL Acct. 833 – A&G Miscellaneous General Advertising
    - GL Acct. 834 – A&G Miscellaneous General
    - GL Acct. 835 – A&G Director Fees and Expenses

- GL Acct. 838 – A&G Annual Meeting
- GL Acct. 954 – Other Deductions – Donations
- GL Acct. 955 – Other Deductions – Envision

- Preparing detailed account activity summaries by payee and by year for identified general ledger accounts for the period 1998 – 2007.

- Evaluating the detailed account activity summaries and identifying select payees for additional review whose total payments exceeded $50,000 during the period 1998 – 2007.

- Preparing detailed payment summaries for identified payees by transaction for the period 1998 – 2007 and evaluating the expenses for business purpose based on information provided in the general ledger (e.g., remark or description) including identification of item purchased.

- Identifying and preparing a summary of all payments made to Messrs. Fuelberg or Burnett identified in the general ledger and evaluating the payments for business purpose based on information provided in the general ledger.

- Identifying and preparing a summary of all expenses identified in the general ledger for which either Messrs. Fuelberg or Dahmann were identified as the approver and evaluating the expenses for business purpose based on information provided in the general ledger.

- Preparing a population of expenses for detailed analysis by combining expense items from the identified general ledger accounts, credit card transactions incurred by or on behalf of Messrs. Fuelberg and Dahmann, credit card transactions incurred on behalf of Mr. Burnett or the Board, general ledger transactions for which Messrs. Fuelberg or Burnett were the payee, and any general ledger transactions that were approved by Mr. Fuelberg or Mr. Dahmann.

- Selecting a random and judgmental sample of expenses for detailed analysis and requesting supporting information from the Cooperative including invoices, receipts and expense vouchers.

- Analyzing supporting documentation provided for sample expenses to identify availability and type of supporting documentation, type of item and number purchased, approving individual, and business purpose.

- Performing a more detailed review of certain expenses identified throughout the investigation including, but not limited to, certain hotel and travel related expenses, service award related expenses, Cooper Clinic invoices, and other expenses involving vendors for which the business purpose of such expenses was not readily apparent.

- Conducting interviews and discussions with current and former Cooperative personnel regarding the expense coding and payment process, identified payees and individual expense items.

2. Limitations on Work Performed

Based on hard-copy and electronic information reviewed and discussions with current and former employees, we have identified that PEC historically made use of the general ledger accounts identified above to book a majority of the Cooperative's discretionary administrative and general expenses. As a result, our work has focused on analyzing these accounts in detail. However, PEC has over 500 general ledger accounts including asset, liability, tax and expense accounts. While we performed a limited review of the transactions made through various other administrative and general accounts, we did not focus our efforts in a comprehensive review of PEC's full general ledger as this analysis was beyond the scope of the investigation.

However, we reviewed all transactions or expenses where Messrs. Fuelberg and Dahmann approved the payment of the expense and all payments to Messrs. Fuelberg and Burnett, including evaluating the expenses for business purpose based on information provided in general ledger and supporting documentation for certain expenses. To our knowledge, Mr. Burnett never approved any payments for expenses.

While the expense process requires the submission of supporting invoices and detail, in many instances that backup detail and support is missing, especially in relation to many expenditures incurred by Mr. Fuelberg. Based on discussions with certain individuals, it is our understanding that Mr. Fuelberg often failed to provide the expense support to both his expense vouchers as well as applicable credit card receipts. As such, our ability to evaluate the purpose, as well as the reasonableness, of certain expenditures is limited by the availability of necessary information describing the nature of the expense.

3. Background

PEC's administrative and general expenses over the past seven years have been significant, totaling over $246 million during the period 2000 – 2007. PEC's administrative and general expenses more than doubled from $17.8 million to $42.6 million during the period 2000 – 2007. A summary of PEC's administrative and general expenses for the period 2000 – 2007 is attached as Exhibit 39.

Over 20% of the total administrative and general expenses related to salaries and wages of PEC personnel and an additional 39% related to employee benefits and retirement (e.g., pension and health benefits) costs. 9.4% of PEC's administrative and general expenses were related to Third Party Service Providers or contract services and 9% were related to data processing (e.g., computer hardware and software and consulting services). $15.9 million (6.4%) in administrative and general expenses related to general miscellaneous expenses and an additional $7.2 million (2.9%) were related to advertising expenses and expenses associated with the annual meeting. A summary of PEC's administrative and general expenses during the period 2000 – 2007 is included below:

Summary of Administrative & General Expenses (2000 - 2007)		
Expense Description	**Total**	**%**
Salaries & Wages	$ 50,718,641	20.6%
Employee Benefits / Retirement (net)	97,431,572	39.5%
Contract Services	23,076,571	9.4%
Data Processing	22,122,745	9.0%
Office Supplies / Miscellaneous	15,890,323	6.4%
Annual Meeting / Advertising	7,189,949	2.9%
Directors Fees & Expenses	5,717,094	2.3%
Other	24,441,798	9.9%
Total	**$ 246,588,693**	**100.0%**

However, it is important to point out that these administrative and general expense amounts are before certain consolidating entries with the Envision subsidiary. Adding the Envision related administrative and general expenses, which averaged approximately $3.8 million per year, would increase the total administrative and general expenses to over $276 million during the period 2000 – 2007.[623]

In comparison to other cooperatives in the United States and Texas, PEC's administrative and general expenses per consumer are significantly higher. During the period 2000 – 2007, PEC had one of the highest administrative and general expenses per consumer compared to cooperatives in Texas and the largest cooperatives in the United States. In 2006 and 2007, PEC's administrative and general expenses per consumer ranked highest among the largest cooperatives in the United States. However, the expenses used to calculate the administrative and general expenses per consumer metric also did not include the Envision related administrative and general expenses. A comparison of PEC's administrative and general expenses per consumer (including Envision) to other cooperatives is summarized in the table below:[624]

Summary of Administrative & General Expenses								
A&G Expense per Consumer	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
PEC (Unconsolidated)	***$122***	***$138***	***$147***	***$162***	***$200***	***$177***	***$183***	***$193***
Envision	***31***	***28***	***20***	***17***	***16***	***18***	***19***	***21***
PEC (Consolidated)	***$153***	***$166***	***$167***	***$179***	***$216***	***$195***	***$202***	***$214***
Large Co-ops Median	$58	$58	$56	$56	$58	$60	$61	$61
U.S. Co-ops Median	86	90	92	96	98	100	106	108
Texas Co-ops Median	68	77	78	77	82	87	91	89
Total A&G Expenses (in millions)								
PEC (Unconsolidated)	$17.8	$21.9	$24.8	$28.9	$37.4	$34.7	$38.6	$42.6
Envision	4.5	4.5	3.4	3.0	3.0	3.5	3.9	4.5
PEC (Consolidated)	$22.3	$26.4	$28.2	$31.9	$40.4	$38.2	$42.5	$47.1

623 Administrative & general expenses of approximately $718,000 for 2006 and 2007 related to the Texas Skies subsidiary were also not included in the total administrative & general expenses.

624 Total administrative and general expenses are based on amounts found in the Cooperative Finance Corporation ("CFC") Key Trend Ratio Analysis. While comparable to the median figures published for the peer group, they differ from the figure for administrative and general expenses found in Pedernales Electric Cooperative, Inc.'s audited financial statements. The administrative and general expenses found in the CFC analysis do not include expenses associated with economic development, consumer accounts, meter reading, consumer assist and records, and uncollectible accounts for bad debts.

PEC also incurred other expenses related to the Envision subsidiary and charitable programs. While these expenses were not categorized as administrative and general expenses by PEC, we believe that these expenses were also discretionary in nature and should be reviewed. A summary of PEC's expenses and the related general ledger accounts is included below.

Summary of Other General Ledger Accounts (2000 - 2007)									
GL Account	2000	2001	2002	2003	2004	2005	2006	2007	Total
954 - Other Deducts-Donations	$133,079	$157,398	$179,397	$193,914	$343,168	$241,123	$650,839	$309,255	$2,208,172
955 - Other Deducts-Envision	112,958	134,014	180,292	151,815	163,123	147,405	158,124	192,934	1,240,665
Total Other Accounts	$246,038	$291,412	$359,689	$345,729	$506,291	$388,528	$808,963	$502,189	$3,448,837

4. Expense Payment Policies and Procedures

Mr. Fuelberg established a purchasing procedure in January 1998 that stated:[625]

> *"All invoices for services with no dollar limit (contract labor/material, tree trimming, janitorial, engineering, consulting, training, printing and legal), merchandise or material inventory non-stocked items less than $1,500, travel, maintenance agreements, membership fees, insurance, taxes, vehicle registrations/tags, minor repair orders, employee benefits, garnishments, subscriptions, postage, utility payments, donations, damage claims, and advertising" are to "be reviewed by the appropriate department manager, approved, coded, and sent to Accounting for payment."*

After approval and payment, a report of the invoices was to be prepared and provided to Mr. Fuelberg for review. Prior to the implementation of this policy, confirmation purchase orders were required for processing items over $250 or for invoices over $1,500 for which the material or service had already been received.

The Board adopted a "Purchasing Policy" in October 2000 outlining that "bids be taken to the maximum extent possible" and that the Board "shall by annual resolution set an amount and/or conditions for purchases, which shall not require a bid process."[626] The policy also authorized the General Manager to "establish procedures and reporting requirements for non-bid items" and required the General Manager to "prepare procedures for the implementation of this policy." A "Purchasing Limit" policy was also adopted by the Board in October 2000 which "set an annual limit of $2,500… for purchases which shall not require a bid process."

Mr. Fuelberg further clarified the purchasing procedure in September 2003 by requiring "a manager's signature before payment is authorized" for "all invoices which exceed $2,000 per month or $25,000 per year."[627] Mr. Fuelberg believed that the manager's signature indicated that the manager had "taken steps to ensure the invoices accurately reflect goods and/or services received by the

[625] Letter from Bennie Fuelberg to All Manager, Re: Confirmation Requisition/Purchase Order Procedure, January 13, 1998.
[626] Pedernales Electric Cooperative, Inc., Board of Directors Purchasing Policy, November 1, 2001.
[627] Letter from Bennie Fuelberg to All Manager, Re: Invoice Approval, September 26, 2003.

Cooperative and necessary to meet its obligations to the membership." The procedure also indicated that "invoices not meeting the above minimums can be paid with supervisor approvals" however, the manager "should ensure they meet the same requirements."

It is our understanding that subject to certain minor limitations, Department and District office managers were authorized or could authorize someone to approve and code the payment of expenses. In addition, it is our understanding that the accounts payable group in the Finance Department essentially served as a processing function with minimal ability to question or re-code expense payments.

5. General Ledger Accounts Identified for Additional Review

As described, PEC's administrative and general expenses per consumer were significantly higher than most other cooperatives during the period 2000 – 2007. As a result, we focused our efforts on administrative and general accounts and other general ledger accounts (i.e., GL Acct. 954 and GL Acct. 955) where the majority of the discretionary expenses incurred by PEC were booked. Based on the hard copy and electronic information reviewed and discussions with current and former employees we identified the general ledger accounts listed below for additional review:

- GL Acct. 820 – A&G Office Supplies (GL Acct. # 820)
- GL Acct. 821 – A&G Contract Services (GL Acct. # 821)
- GL Acct. 833 – A&G Miscellaneous General Advertising (GL Acct. # 833)
- GL Acct. 834 – A&G Miscellaneous General (GL Acct. # 834)
- GL Acct. 835 – A&G Director Fees and Expenses (GL Acct. # 835)
- GL Acct. 838 – A&G Annual Meeting (GL Acct. # 838)
- GL Acct. 954 – Other Deductions – Donations (GL Acct. # 954)
- GL Acct. 955 – Other Deductions – Envision (GL Acct. # 955)

We prepared account activity summaries by payee and by year for each identified general ledger account for the period 1998 – 2007. Our analysis included an evaluation of approximately 65,000 general ledger transactions in these accounts during the period under investigation totaling in excess of $60 million. The total expense transactions during the period 1998 – 2007 for each general ledger account are summarized below.

Summary of Expense Transactions for Identified General Ledger Accounts

GL Acct	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
820 - A&G-Office Supplies	$971,412	$1,184,086	$1,400,263	$1,495,668	$1,289,798	$992,885	$948,420	$1,108,719	$1,450,322	$1,763,459	$12,605,032
821 - A&G-Contract Services	938,007	1,065,106	1,275,361	1,655,573	2,056,036	3,629,424	4,210,787	2,084,037	2,388,984	4,930,451	24,233,766
833 - A&G - Misc. Gen. Advertising	102,372	195,659	447,452	453,187	444,063	535,325	509,981	293,470	592,127	1,068,583	4,642,218
834 - A&G- Misc. General	457,423	425,698	673,445	741,513	797,315	138,266	1,085,316	490,667	725,373	765,181	6,300,196
835 - A&G-Director Fees & Expenses	377,709	486,362	448,509	676,653	752,502	747,107	692,937	743,500	833,053	822,834	6,581,165
838 - A&G-Annual Meeting	152,444	167,867	360,462	221,659	364,099	410,807	410,668	264,458	313,027	500,582	3,166,073
954 - Other Deducts - Donations	87,938	93,503	133,079	157,398	179,397	193,914	343,168	241,123	650,839	309,255	2,389,613
955- Other Deducts - Envison	278,698	122,576	112,958	134,014	180,292	151,815	163,123	147,405	158,124	192,934	1,641,939
Total	**$3,366,002**	**$3,740,858**	**$4,851,529**	**$5,535,664**	**$6,063,500**	**$6,799,543**	**$8,364,400**	**$5,373,378**	**$7,111,850**	**$10,353,278**	**$61,560,002**

We focused our review on payees in each of the accounts whose total payments exceeded $50,000 during the period 1998 – 2007. During our review of payments to select payees we evaluated the information contained in the general ledger including the remarks and requested detailed supporting information for certain expense payments.

GL Acct. # 820 – Office Supplies and GL Acct. # 834 – Miscellaneous General

While we completed an analysis of all expenses incurred by Messrs. Fuelberg, Burnett and Dahmann that were booked to GL Acct. # 820, an item by item analysis of all of PEC's expenses booked to GL Acct. # 820 and GL Acct. # 834 is beyond the scope of the investigation. However, a limited review of the various expenses across the years reveals that the purchases were varied across numerous vendors, expense types, amounts and expense purposes. GL Acct. # 820 was used for a variety of general miscellaneous expenses including office supplies, telecommunication expenses, and various travel and entertainment related expenses. GL Acct. # 834 was also used for general miscellaneous expenses including coffee and coke deposits, flowers and legislative dinners.

Our efforts were focused on expenses incurred and approved by Messrs. Fuelberg, Burnett and Dahmann that were incurred by, or on their behalf, in relation to their Cooperative-issued credit cards and the personal expense voucher process. However, as described, a sample of expenses was reviewed in detail which included expenses from GL Acct. # 820 and GL Acct. # 834, but excluded certain expenses related to Messrs. Fuelberg, Burnett and Dahmann. Expenses incurred by Messrs. Fuelberg, Burnett and Dahmann are addressed in a previous section of this Report (i.e., *Senior Management Expenses/Expense Reimbursement).*

GL Acct. # 835 – Director Fees and Expenses and GL Acct. # 821 – Contract Services

Board related expenses were routinely booked to GL Acct. # 835. Expenses related to Third Party Service Providers such as consultants, lobbyists, and attorneys were booked to GL Acct. # 821. Expenses booked to GL Acct. # 835 and GL Acct. # 821 are addressed in previous sections of this Report (i.e., *Director Compensation and Benefits, Director Expenses/Expense Reimbursement* and *Third Party Service Providers*).

GL Acct. # 955 – Other Deductions - Envision

Expenses incurred by the Cooperative related to Envision were booked to GL Acct. # 955 including Messrs. Fuelberg and Burnett's travel expenses to New Mexico for Envision Board meetings and other matters. Expenses booked to GL Acct. # 955 are addressed in previous sections of this Report (i.e., *Senior Management Expenses/Expense Reimbursement* and *Envision Utility Software Corporation*).

GL Acct. # 833 – Advertising Expenses

Advertising expenses including classified ads for employment, and radio and television advertisements, were booked to GL Acct. # 833. Advertising expenses booked to GL Acct. 833 averaged $464,222 per year during the period 1998 – 2007 totaling $4,642,218. Approximately two thirds ($3.1 million) of the expenses were related to advertising and classified ads in newspapers, magazines and television. Approximately $210,000 of expenses were fees incurred by recruiting agencies related to employee recruitment.

<u>GL Acct. # 838 – Annual Meeting Expenses</u>

GL Acct. # 838 was used for expenses related to the annual meeting including costs associated with video production and service awards. Expenses booked to GL Acct. 838 averaged $316,607 during the period 1998 – 2007 totaling over $3.1 million. Approximately 30% ($949,000) of the expenses related to postage and approximately $275,000 of the expense payments were related to printing and copying services, presumably for the packets mailed to each member. Expenses totaling approximately $300,000 appear to relate to advertising costs and expenses of at least $350,000 are related to production of a video. In addition, approximately $130,000 of expenses appear to be related to service awards.

<u>GL Acct. # 954 – Other Deductions – Donations</u>

GL Acct. # 954 was used for charitable related expenses including United Charities and other contributions. Expenses booked to GL Acct. # 954 totaled over $2.3 million during the period 1998 – 2007, an average of $238,961 per year. Almost half ($1.1 million) of the expenses were the Board approved matching contributions to United Charities. Approximately $135,000 of the expenses were associated with the Cooperative's annual golf tournament.[628] The Cooperative also made yearly donations to approximately 70 different community organizations including, but not limited to, chambers of commerce, fire departments, 4H and FFA organizations, and libraries. These donations totaled over $650,000 during the period 1998 – 2007, however, the total donation to each entity was less than $10,000. The amount of the individual donations increased from $150 in 1998 to $1,500 in 2006. The donations to individual community organizations were stopped in 2007, which resulted in approximately $345,000 less in expenses during 2007 as compared to 2006.

In addition, payments totaling $150,000 in 2006 and $100,000 in 2007 to Guadalupe Valley Electric Cooperative ("GVEC") were booked to GL Acct. # 954 relating to the Wholesale Power Alliance. A cover letter for one of the payments stated:[629]

> *"Enclosed is a check payable to GVEC to be used by the Wholesale Power Alliance to further its'* (sic) *efforts in finding alternatives to LCRA power. While Pedernales Electric Cooperative is not joining the Alliance, we do support the other customers' quest for a less 'Authoritarian' power supply and will keep you informed of our efforts when possible."*

The 2006 and 2007 payments were approved by Board resolutions that stated, "the Cooperative will make a donation in the amount of $50,000 to the Wholesale Power Alliance group," "General Manager Fuelberg is authorized to contribute up to $100,000 to the Wholesale Power Alliance" and

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628 Pedernales Electric Cooperative, Inc. United Charities is addressed in greater detail in another section of this Report.

629 Letter from Bennie Fuelberg to Mr. Darren Schauer, General Manager Guadalupe Valley Electric Cooperative, Inc. Re:, Wholesale Power Alliance, April 28, 2006.

"General Manager Fuelberg is authorized to contribute up to an additional $200,000 to the Wholesale Power Alliance."[630]

As described in another section of this Report, the Wholesale Power Alliance ("WPA") was organized by a group of the LCRA wholesale electric customers to negotiate a new wholesale power agreement in which PEC was not a member.[631] We have been unable to determine with specificity the reason that PEC was not a member of the WPA, why these payments were made or why these payments were made indirectly to the Wholesale Power Alliance through GVEC. However, while PEC was not an explicit member of the WPA, it appears that PEC, at a minimum, supported the WPA with monetary donations.

6. Payments to Messrs. Fuelberg or Burnett

As described, we prepared account activity summaries for payments to Messrs. Fuelberg and Burnett across the general ledger. Our analysis included an evaluation of approximately 90 payments during the 1998 – 2007 time period totaling in excess of $196,000. A majority of these payments relate to expense reimbursements and travel advances to Mr. Fuelberg and Mr. Burnett. These expense reimbursements and travel advances are addressed in another section of this Report.

7. Expense Payments Approved by Messrs. Fuelberg or Dahmann

We also prepared account activity summaries for expense payments that were approved by Messrs. Fuelberg or Dahmann across the general ledger. Our analysis included an evaluation of approximately 1,490 expense payments approved by Messrs. Fuelberg or Dahmann during the period 2003 – 2007 totaling in excess of $31 million.[632] Approximately 560 of the expense payments relate to capital calls for Envision or payments to Third Party Service Providers including payments to Clark Thomas. The remaining expense payments relate to travel and other administrative and general expenses including flowers and meals. We evaluated the information contained in the general ledger for select payees and payments including requesting detailed supporting information for certain expense payments.

8. Sample Expense Payment Population Identified for Detailed Analysis

We completed a detailed analysis of 228 expense payments including a review of the supporting documentation. A population of expense items was prepared by combining expense items from the identified general ledger accounts, credit card transactions incurred by or on behalf of Messrs. Fuelberg and Dahmann, credit card transactions incurred on behalf of Mr. Burnett or the Board, general ledger transactions where Messrs. Fuelberg or Burnett were the payee; and any general

[630] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., April 17, 2006, Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., December 11, 2006, and Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., February 26, 2007.

[631] Minutes of Meeting of Board of Directors, Pedernales Electric Cooperative, Inc., March 20, 2006.

[632] Pedernales Electric Cooperative, Inc. utilized the "approved" field in the general ledger during the period October 2003 – 2007.

ledger transactions that were approved by Mr. Fuelberg, Mr. Dahmann or the Board.[633] 45,609 expense payments totaling $47,985,372 were included in the initial population. However, we limited the population for sampling purposes to expense payments greater than $500. As a result, the expense payment population was reduced to 8,878 expense payments.[634] However, these expense payments totaled $31,703,055 which was 66.1% of the initial population amount of $47,985,372.

From this population, a judgmental sample of 79 expense payments and a random sample of 149 expense payments were selected for detailed analysis. The expense items in the judgmental sample were selected based on the information contained in the payee and remark fields in the general ledger and the amount of the payment. The expense items in the random sample were selected by applying a random number generator to the remaining population after the judgmental sample had been selected. The 228 expense payments (sample population) are summarized below by account:

Summary of Sample Expense Payments by GL Account

GL Account	# of Transactions
820 - A&G - Office Supplies	68
826 - A&G - Emp Pension & Benefits	53
833 - A&G - Misc. Gen. Advertising	21
834 - A&G - Misc. General	12
835 - A&G - Director Fees & Expenses	15
838 - A&G - Annual Meeting	35
954 - Other Deducts - Donations	18
955 - Other Deducts - Envison	3
Other	3
Total	**228**

We conducted an analysis of the expense payments in the sample population including an analysis of the supporting documentation (i.e., invoices, receipts and expense vouchers). Our efforts focused on identifying the availability and type of supporting documentation; the type of item; the number of items purchased; expense payment approver, and the indicated business purpose.

9. Additional Expense Payments Reviewed

In addition to the work steps described above, throughout the course of the investigation we reviewed an estimated additional 125 expense payments and the supporting detail for the transactions. This additional review of certain expense payments included certain hotel and travel

[633] Certain items were removed from the general ledger accounts including credit card transactions, refunds and reclassified, accrual and payroll items as the information contained in the general ledger for these transactions was limited. However, credit card transactions on or behalf of Messrs. Fuelberg, Burnett and Dahmann and the Board were included in the expense population.

[634] Certain additional items were removed from the expense payment population including entries related to reversals and corrections, payments from GL Account 312 - Investment - Envision Software, monthly adjustments for uncollectibles from GL Account 834 and allocations to Water Co. (reclassed from 820 to 964).

related expenses; service award related expenses; Cooper Clinic invoices; and other expenses involving vendors where the business purpose of such expenses was not readily apparent.

C. Observations and Findings

1. Administrative and General and Other Discretionary Expenses

PEC's administrative and general expenses more than doubled from $17.8 million to $42.6 million during the period 2000 – 2007 totaling over $246 million. Over 50% of the costs related to salaries and wages, Third Party Service Provider and Director fees and expenses, advertising and annual meeting expenses, and office supplies and general miscellaneous expenses. PEC consistently had one of the highest administrative and general expenses per consumer compared to Texas cooperatives and the largest cooperatives in the United States during the period 2000 – 2007. While differences exist between various cooperatives, their respective regions and the demographics of their members, the fact that PEC has significantly higher administrative and general expenses per consumer is reflective, in part, of PEC's financial management practices including virtually non-existent budgets, lax expense controls and limited expense reporting processes. Under the tone established by Mr. Fuelberg, there appear to have been few limitations on what was considered an acceptable expense.

The expenses reviewed appear to have been related, at least to some degree, to the conduct of the Cooperative's business, or provided benefit to PEC's former Senior Management, managers, Directors, or the employees of the Cooperative in a business context. However, the Cooperative incurred significant expenses in areas that appear to provide limited value to the Cooperative including certain advertising and annual meeting related expenses. As the sole provider of electricity for its service area, PEC should have a limited need for advertising. Advertising expenses have decreased significantly during 2008 as a result of certain cost-saving measures implemented. Advertising expenses incurred by the Cooperative during 2008 were approximately $614,305 less than the expenses incurred during 2007 which represents a 68.3% decrease.[635] In addition, expenses totaling over $675,000 were incurred related to the production of a video and advertising for the annual meeting during the period 1998 - 2007. Expenses incurred by Senior Management and the Directors and fees paid to Third Party Service Providers are addressed in detail in other sections of this Report.

2. Limited Expense Policies and Procedures

We did not identify a defined expense payment policy other than the informal/ad hoc rules or guidelines established by Mr. Fuelberg. While these informal guidelines established pre-determined spending limits, expense levels or ranges, and expenditure authorization or approval requirements, the authority was delegated to the managers of the Departments and District offices and limited the ability of the Finance Department to review or question the expenses.

[635] Year to date through September 2007 and 2008.

3. Limited Audit/Review Process

There appears to have been limited to no review or audit of expense payments by the Finance Department. In addition to the lack of a defined expense payment policy, it is our understanding that the accounts payable function was not allowed to question and/or deny an expense payment if it had proper approval from a manager. A fundamental internal control requires that organizations and their employees document expenses incurred in the conduct of the organization's activities to evidence reasonableness and relatedness to the objectives of the Cooperative. However, the Finance Manager and his staff were relegated to the role of merely processing the expenses and payments.

4. Lack of Meaningful Reporting Function

In addition to the limited transparency into expenses incurred by the Cooperative and former Senior Management, there appears to have been no reporting mechanism for keeping either the Board or Senior Management informed of the types and amounts of expenditures being incurred by PEC. While the expenses and payments were paid through PEC's accounts payable process and tracked in PEC's general ledger, PEC managers were responsible for their own expense coding. Hence, even if someone was evaluating expenses charged to a particular general ledger account, there was no guarantee, or assurance, that expenses were being recorded to the proper accounts.

The Board also was limited in its ability to review expenses and payments. The October 2000 Board adopted "Purchasing Policy" outlined that the "Board of Directors shall receive a report monthly on all materials, equipment, supplies and services for which the Cooperative has contracted whether through purchase orders, by bids or through other means."[636] The Board was provided such a report (checks over $2,500 report) in the Board package sent to each Director prior to the monthly Board meeting. However, the report was typically 10 – 15 pages in length and difficult to analyze and understand as it did not provide a description of the expenses, "year-to-date" total expenses for payees or categorize payments by expense category or type. As a result, the Board's ability to evaluate the expenses incurred by PEC in total was limited.

5. Limited Use of Purchasing Function

The investigation found evidence of certain large expenditures handled as reimbursements that should have been properly handled through the purchasing or procurement process, in order to ensure that proper controls were followed and that reasonable prices were obtained for the items acquired. Not only did the Cooperative not have travel and expense guidelines or established spending limits, there also appeared to have been very limited spending constraints placed on Cooperative employees in the use of the Cooperative-issued credit cards. Large expenses were identified of such significant magnitude that they should have been subject to a more formal process involving the Finance Manager and his Department, as well as, potentially, the purchasing and/or the fixed assets group, in order to ensure that prices were reasonable and appropriate and that proper approvals were obtained.

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[636] Pedernales Electric Cooperative, Inc., Board of Directors Purchasing Policy, November 1, 2001.

6. Sample Expense Population

We found that some form of backup detail or supporting documentation was available for a majority of the 228 expense payments included in the sample population. We identified eight expenses out of the 228 that did not have backup or supporting detail. Five of these eight expenses were transactions related to a "transportation allocation" which do not have any type of support documentation as the expense is an allocation of transportation costs of the Cooperative. The remaining three appear to relate to hotel expenses for an NRECA meeting.

We were also able to identify the item(s) purchased for all 220 and a business related purpose for 211 of the 220 expenses for which we received some form of backup detail or supporting documentation. Six of the nine expenses in which we have been unable to identify a business related purpose appear to relate to service awards or door prizes as the items purchased (e.g., televisions, watches and guns) are similar to other items historically purchased for service awards and door prizes. We have been unable to determine a business related purpose for the remaining three expenses. However, the expenses appear, based on the general ledger information, supporting documentation and discussions with Cooperative personnel, to relate to a catered lunch and supplies purchased for use at the Cooperative.

7. Evaluation of Expenses – Reasonable and Necessary

While all of the expenses reviewed appear to have been related to some degree to the conduct of the Cooperative's business, or provided benefit to PEC's Senior Management, PEC managers, the Directors, or the employees of the Cooperative in a business context, certain expenses, could be questioned. As described, we conducted a broad review of transactions and expense payments in the identified general ledger accounts and a detailed analysis of a sample of expense payments. These work steps were designed to address certain allegations from the media and class action lawsuit regarding excessive expenses. The majority of these allegations were primarily related to expenses incurred by former Senior Management and the Directors and are addressed in other sections of this Report. However, through the course of our evaluation of the administrative and general and other discretionary expenses we identified a number of expense payments where similar questions could be raised. These expenses were typically included in the judgmental sample for further review.

Many of the questionable expenses identified were incurred for employee service awards based on years of service. As a large cooperative, with over 800 employees, PEC routinely provided both safety and service awards to recognize individuals for their contributions to the Cooperative. A 2001 memorandum outlining the service award levels stated: [637]

[637] Letter from Will Dahmann to All Manager Subject: Service Awards, March 7, 2001.

"The years of service dollar value for the Service Awards Program has been changed for calendar year 2001 as follows:

Years of Service	*2001 Dollar Value*
5 years	*$175*
10 years	*$300*
15 years	*$500*
20 years	*$700*
25 years	*$900**
30 years	*$1,025**
35 years	*$1,200**
40 years	*$1,350**

**All awards for 25 years or more will be selected by the employee.*

As in the past, the awards will be presented at the Annual Meeting."

In addition, after a review of the supporting documentation, we identified that service awards were often purchased in bulk (e.g., twenty-five $250 watches would be purchased from a jewelry store). A summary of a select expense transactions related to service awards is included below:

Summary of Select Expense Transactions

		General Ledger Data			**Identified**
GL Date	**Object**	**Explanation**	**Remark**	**Amount**	**Business Purpose**
4/16/1998	826 - A&G-Emp Pension & Benefits	SAVUTH TE'S JEWELRY & G	BENEFIT-EMPLOYEE	930.00	Service Award
5/31/2001	826 - A&G-Emp Pension & Benefits	CIRCUIT CITY CORPORATE	BENEFIT-EMPLOYEE	2,143.84	Service Award
5/23/2002	838 - A&G-Annual Meeting	Circuit City Corporate Sales O	Sony 27" TV	4,725.00	Service Award
5/29/2002	838 - A&G-Annual Meeting	Salem's Jewelery	Annual Meeting-Service Award	9,750.00	Service Award
4/18/2003	838 - A&G-Annual Meeting	Savuth Te Jewelry & Goldsmith	Annual Meeting-Service Award	1,500.00	Service Award
4/30/2003	838 - A&G-Annual Meeting	Bike World	Annual Meeting-Service Award	1,441.94	Service Award
5/1/2003	838 - A&G-Annual Meeting	Circuit City Corporate Sales O	Panasonic 53" Widescreen TV	1,495.00	Service Award
5/18/2004	838 - A&G-Annual Meeting	Bose Corporation	Service Award-Music System	27,298.00	Service Award
7/13/2004	826 - A&G-Emp Pension & Benefits	Sam's Club	Benefit-Service Awards	3,579.70	Service Award
6/21/2006	826 - A&G-Emp Pension & Benefits	Nagels Gun Shop	Service Award	2,250.00	Service Award

The distinction between what was reasonable and necessary, versus excessive, is a subjective one at best. However, while reasonable explanations and motivations likely exist for a number of the expenditures, in reality the expense practices at PEC went largely unchecked. As described, the tone was established by Mr. Fuelberg with regard to what was considered a reasonable and necessary business expense versus what might have been considered excessive. Under the tone established by Mr. Fuelberg, there appear to have been few limitations on what was considered an unacceptable expense and that tone apparently translated into a credit card and expense reimbursement and payment process where few exercised the restraint many would consider prudent in a member-owned Cooperative. As a result, PEC's administrative and general expenses were comparatively higher than other Texas cooperatives and the largest cooperatives in the United States.

D. Recommendations

New Policies and Procedures

- It is recommended that PEC establish new policies and procedures for the Cooperative's expenditures specifically related to administrative and general and other discretionary expenses. The new policy should establish specific guidelines regarding amounts, when, and for whom, prior authorization is required for expenditures.

Expense Audit and Review Process

- It is also recommended that Cooperative, as well as all Senior Management and employee expenses, be subject to review, evaluation and audit by the Finance Department. This review should entail ensuring that all expenses are properly approved, coded and supported by underlying invoices and receipts as required by the Cooperative's policies and procedures. The designated reviewers should have the authority to deny reimbursement of certain expenses unless they are satisfied that the established policies and procedures are met.

- It is also recommended that an expense limit should be established for items exceeding a certain dollar amount, with higher-level approval being required, including approval by the CFO or General Manager. Certain types of expenditures should not be permissible through the Cooperative-issued credit cards or expense voucher process, unless under unusual and extreme circumstances. These defined types of expenditures should be specified as subject to processing only through the Cooperative's purchasing and procurement procedure.

Administrative and General and Other Discretionary Expenses

- It is recommended that PEC evaluate areas to reduce administrative and general and other discretionary expenses going forward. As described, PEC has had one of the highest administrative and general expenses per consumer compared to Texas cooperatives and the largest cooperatives in the United States during the period 2000 – 2007. All administrative and general and other discretionary expense accounts should be reviewed to identify areas for potential cost savings.

Budgets used for Evaluated of Reasonable Expenses

- It is recommended that PEC also establish the use of budgets and expense variance reporting for administrative and general expenditures to provide reporting to assist in evaluating the reasonableness of expenses being incurred by the Cooperative.

XXVII. Political Contributions Account

A. Background

The existence of a political contributions account in the name of "BF Trustee Account" ("Political Contributions Account") was identified during the course of the investigation.[638] The Political Contributions Account was in existence from at least 1999 through 2007 and appears to have been funded through contributions from the Directors. The funds in the account were apparently used to make donations to various political campaigns and other political action committees, including the Rural Friends/ACRE (Action Committee for Rural Electrification) PAC, a nonpartisan political action committee that helps supporters of electric cooperatives seeking office in the Texas Legislature or the U.S. Congress. While the bank account was not in PEC's name, nor were the funds in the account recorded in the books and records of PEC, it is our understanding that the bank statements were addressed to the attention of Bennie Fuelberg at PEC's corporate address in Johnson City and the account was managed by Mr. Fuelberg and his assistants.

1. Scope of Work

In light of the questions raised regarding the Political Contributions Account, the scope of our efforts expanded to include the research and investigation of the account, including the purpose and source of funds in the Political Contributions Account and whether PEC has any ownership of and/or claim to the funds in that account. Our efforts were focused on identifying information in PEC's possession relating to the Political Contributions Account, including a search of PEC's electronic data management system (EDMS), a detailed search for historical hard-copy documentation, and discussions with various employees in the General Manager Department. However, only limited information was identified relating to the Political Contributions Account.

More specifically, the scope of our work included the following:

- Identifying and reviewing electronic and hard copy information related to the Political Contributions Account, including correspondence and Board meeting notes.

- Analyzing and reviewing summary financial information related to the Political Contributions Account, including an Excel spreadsheet maintained for the period 1999 - 2003.

- Identifying and reviewing information related to the Political Contributions Account identified through third-party sources including donation records.

- Conducting interviews and discussions with current Cooperative personnel regarding the Political Contributions Account.

[638] Other materials we have reviewed identify the account as the "Political Account – Bennie Fuelberg, Trustee" or "PAC Account."

2. Limitations on Work Performed

Based on a review of hard copy and electronic information and interviews with current and former PEC personnel, we determined that detailed information related to the Political Contributions Account was not available. We have not identified any bank statements or other financial records related to the Political Contributions Account other than an Excel spreadsheet containing summary financial information for the period 1999 – 2003. It is our understanding that hard copy information related to the Political Contributions Account was taken by Mr. Fuelberg when he resigned from the Cooperative. As a result, we had limited information on which to base our observations.

3. Summary of Political Contributions Account Transactions

As described, we identified an Excel spreadsheet containing summary financial information related to the Political Contributions Account during the period 1999 – 2003. We identified four deposits totaling $33,750 and eight disbursements totaling $19,044 during the period 1999 – 2003.[639] A summary of the account activity for the Political Contributions Account during the period 1999 – 2003 is included below:

Summary of Political Contributions Account Transactions (1999 - 2003)

	1999	2000	2001	2002	2003
Beginning Balance	$ 789	$ 11,358	$ 9,511	$ 9,631	$ 6,875
Deposits	10,500	-	-	12,000	11,250
Disbursements	-	(2,000)	-	(14,800)	(2,244)
Service Charges	(35)	-	-	-	-
Interest Earned	104	153	120	45	20
Ending Balance	**$ 11,358**	**$ 9,511**	**$ 9,631**	**$ 6,875**	**$ 15,901**

Based on the review of limited correspondence and other information and discussions with PEC personnel, it appears that contributions were made by the Directors on an as-needed basis when the account balance in the Political Contributions Account was low. It is our understanding that Directors would write personal checks for their respective donations to be deposited into the Political Contributions Account. Although it is our understanding that contribution checks were written on the account and signed by Mr. Fuelberg as the account signatory, Mr. Fuelberg would transmit the contribution with a cover letter that outlined the donation amount from each Director and himself.

B. Observations and Findings

1. Board was Aware of Political Contributions Account

The Board was aware of the Political Contributions Account's existence and made contributions to the account. In addition, it appears the Board was generally knowledgeable of the donations made from the account to the various political campaigns and other political action committees.

[639] Political Account – Bennie Fuelberg, Trustee, Detail by Reference No. and Bank Reconciliation Report.

2. Contributions Indirectly Funded by the Cooperative

As discussed in other sections of this Report, we identified several occasions each year from 1998 - 2007 on which PEC's Board would hold more than one meeting in a day (sometimes three in one day) and Directors would receive separate $750 per-meeting fees for each meeting. Throughout the ten-year period of investigation, we identified 26 dates on which at least two Board-related meetings were held and for which the attending Directors received multiple per-meeting fee payments for their attendance. Based on a review of hard copy and electronic information and interviews with current and former PEC personnel, we have identified two instances during the period 1999 – 2003 for which the dates of the deposit into the Political Contributions Account coincide with dates on which the Board held more than one meeting and received separate $750 per-meeting fees for each meeting. In addition, the deposits into the Political Contributions Account were in multiples of $750 (e.g., $12,000, $11,250). This is consistent with the per-meeting fee received by the Directors for the additional meeting and the number of Directors on the Board, excluding W.W. Burnett, who did not receive per-meeting fees.[640]

However, as described, it is our understanding that the per-meeting fees were not directly deposited into the Political Contributions Account, as the Directors were writing personal checks for the contributions. While it appears that the Political Contributions Account was not necessarily directly funded through the per-meeting fees received by the Directors for multiple meetings in one day, the correlation between the contributions made and the timing and amounts compensated to Directors for these special Board meetings raises questions regarding the appropriateness of the Political Contributions Account funding. Under Texas law, as construed by the Texas Ethics Commission, generally a corporation may not reimburse employees for their contributions to a PAC because such reimbursements are tantamount to prohibited donations by the corporation.[641]

3. Donations Made on Behalf of Mr. Fuelberg

As described, it appears the Political Contributions Account was funded by the Directors. It is unclear whether Messrs. Fuelberg or Burnett also contributed to the account. It is our understanding that Mr. Fuelberg did not himself make contributions to the Political Contributions Account. However, we have identified instances in which donations from the Political Contributions Account to political campaigns and other organizations were also made on behalf of Messrs. Fuelberg and Burnett.

C. Recommendations

Use of Political Contributions Accounts

- The future use of Political Contributions Accounts may be appropriate for PEC, as determined by the PEC Board and subject to the advice of legal counsel. It is recommended that any use of them be undertaken in a manner that is both transparent and fully consistent with applicable laws and regulations.

[640] The $11,250 deposit consisted of two separate deposits of $7,500 and $3,750.

[641] Texas Ethics Commission Ethics Advisory Opinion No. 362 at 1 (1997).

Policies and Procedures Regarding Political Contributions by Cooperative Employees

- It is recommended that PEC adopt policies and procedures addressing the respective guidelines and limitations regarding the contributions by employees, as well as Directors, to political action committees (PACs) or for other political purposes to ensure that the contributions are not reimbursed by the Cooperative..