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Joel I. Klein, Esquire
Assistant Attorney General
Antitrust Division
Main Justice Building
10th and Constitution Ave.
Washington, D.C. 20530

RE: Request for Statement of Enforcement Intentions Pursuant to Business Review Procedures.

Dear Mr. Klein:

On behalf of the seventeen rural electric distribution cooperatives of Arkansas (the "Distribution Cooperatives") and their joint venture, Arkansas Electric Cooperative Corporation[1] ("AECC"), we hereby request through this letter a statement of the Antitrust Division's present enforcement intentions with respect to the proposed plan of operation for the retail sale of electricity set forth below. It is our belief that the proposed joint venture complies with the FTC/DOJ Antitrust Guidelines for Collaborations Among Competitors and will provide a new, viable competitor providing low cost energy for the electric consumers of Arkansas.

Background

The Distribution Cooperatives are seventeen separate, nonprofit cooperative corporations formed pursuant to the Electric Cooperative Corporation Act of Arkansas to provide electric service predominantly to rural consumers. Rural persons historically had not been served by investor-owned utilities. With the enactment of the Federal Rural Electrification Act of 1935, the

[1] Sixteen of the seventeen rural electric distribution cooperatives are members of and purchase electricity from AECC. The other distribution cooperative is not presently a member and does not purchase electricity from AECC, but is anticipated to become a member in the future.

Federal government promoted and assisted the formation of rural electric cooperatives in order to bring electric energy to rural citizens.

A cooperative, such as each of the Distribution Cooperatives, is formed on behalf of and is owned by the individual member/consumers that are served by the cooperative. A cooperative generally operates like a regular corporation, except that a cooperative is legally obligated to distribute annually all of its income from business done with or for its member/consumers through the payment of a patronage dividend to its member/consumers based upon the value or volume of business done by the cooperative with such member/consumers.

Sixteen of the Distribution Cooperatives currently own and operate a joint venture called Arkansas Electric Cooperative Corporation which was formed as a cooperative in 1949 for the purpose of providing a stable source of low-cost electricity for those Distribution Cooperatives. These Distribution Cooperatives, through AECC, presently own all of, or interests in, ten electric generation plants. AECC provides electric power, on a nonprofit basis, for sixteen of the Distribution Cooperatives on an all-requirements basis through its electric generation facilities and through wholesale power purchases. The Distribution Cooperatives, in turn, sell electricity to their respective member/consumers on a nonprofit basis.

Arkansas Implementation of Retail Competition

In 1999, Arkansas enacted the Electric Consumer Choice Act of 1999, (the "Act") mandating competition in the retail sale of electricity, and for certain other electric services which might thereafter be declared competitive by the Arkansas Public Service Commission (the "PSC"), beginning as early as January 1, 2002. The Act will significantly change the way retail electricity is purchased and sold within the State of Arkansas. Currently, electric energy may only be purchased by consumers from the regulated electric utility serving the territory in which the consumer is located. Under the Act, a consumer will be allowed to purchase electric energy from anyone in the competitive marketplace, and the consumer's incumbent utility will have to deliver that electricity to the consumer's door under regulated distribution charges.

The Act will require utilities to separate the transmission, distribution and generation functions of their business from the retail sale of electricity. This functional separation is required to be accomplished through the creation of separate divisions or departments, nonaffiliated companies, separate affiliated companies owned by a common holding company, or through the sale of assets to a third party. The primary focus is the separation of the retail marketing activities, which will be completely competitive, from the regulated electric utility activities involved in the transmission and distribution activities. The Act provides that the retail marketing of electricity may be conducted through an energy service provider.

In order to ensure that the utility's marketing operations do not improperly benefit from the relationship with an electric utility, the Act provides that the electric utility must conform to certain specified affiliate rules or codes of conduct. These rules generally provide that electric utility employees engaged in the transmission and distribution system operations must function independently of its employees, or employees of an affiliate, engaged in the marketing or sale of electricity at retail.

The Act also creates the obligation for each incumbent utility to offer a standard service package to any consumer that has not elected an alternative energy service provider or to any consumer that has not been able to secure an alternative energy service provider.[2] Such consumers are commonly referred to as "default customers". Under the provisions of the Act, the Distribution Cooperatives may serve the default customers directly or assign default customers to an affiliate.

The rates for the standard service package will be a market rate unless the incumbent utility chooses to offer a regulated rate approved by the PSC. With respect to default customers served by the Distribution Cooperatives, any regulated rate would be proposed by each Distribution Cooperative and then submitted to the PSC for approval.

Proposed Plan of Operation

The Distribution Cooperatives propose using their existing joint venture, AECC, to create an energy service provider (the "ESP") to enter retail electric competition in Arkansas. The principal place of business for the ESP will be 8000 Scott Hamilton Drive, Little Rock, Arkansas 72209. The Distribution Cooperatives will implement the ESP through a two-stage process. The ESP will purchase the electricity to sell at retail from AECC and will become a member of AECC.

In the first stage, the Distribution Cooperatives will cause AECC to form the ESP subsidiary which will be formed as a single member limited liability company. The Distribution Cooperatives through their equity holdings in AECC will make the substantial financial contribution necessary to establish the ESP. AECC will operate the ESP through the start up and market development phase. After the ESP is up and operating, with retail competition active in Arkansas, the Distribution Cooperatives anticipate converting the ESP structure to the second stage. This will occur when the Distribution Cooperatives deem the ESP to be sufficiently profitable to warrant the return of its profits (through the payment of patronage dividends) to the consumers. At that time, each Distribution Cooperative will become an individual member of the ESP limited liability company, and AECC will convert its interest in the ESP to a preferred ownership

[2] See § 23-19-402(a) of the Act.

interest. The two stages are graphically represented in Exhibit A and Exhibit B attached hereto.

Under the ESP's operating agreement, the Distribution Cooperatives will agree to conduct all of their competitive retail marketing activities through the ESP. If a Distribution Cooperative decides to cease to be a member of the ESP, the departing Distribution Cooperative may compete with the ESP for any and all consumers. Each Distribution Cooperative will individually decide whether to directly serve its default customers or assign its default customers to the ESP.

It is anticipated that a large majority of the Distribution Cooperatives will elect to retain the default customers for themselves rather than assigning them to the ESP and will further to elect to provide a regulated rate to the default customers as approved by the PSC.

Under these likely circumstances, the ESP will compete with the Distribution Cooperatives to serve the default customers and the Distribution Cooperatives will, in effect, compete with the ESP by offering a regulated rate approved by the PSC to any consumer who does not or cannot participate in the competitive marketplace.

ESP Joint Venture

Although the Distribution Cooperatives are utilizing their current investment in AECC through the two stage approach described above, the ESP is a joint venture of the Distribution Cooperatives. Under the FTC/DOJ Antitrust Guidelines for Collaborations Among Competitors, an evaluation of the potential procompetitive benefits must be compared to the anticompetitive harms.

As explained below, the efficiencies created by the ESP are enormous. If the Distribution Cooperatives are not able to realize these efficiencies through the ESP, the likely cost involved in their competing individually would prevent the Distribution Cooperatives from being able to effectively compete in the retail electricity market in Arkansas, thus eliminating a potential competitor for the investor-owned utilities who likely will operate in Arkansas. In addition, a joint venture among the Distribution Cooperatives is unlikely to cause any anticompetitive harm due to the lack of market power collectively possessed by the Distribution Cooperatives.

Lack of Market Power

A market power study has been prepared which analyzes the effect of the ESP in the markets in which it will compete. The study found that the creation of the ESP would not improperly combine transmission facilities and distribution facilities, since transmission and distribution remain regulated under the Act. The study also found that the ESP's creation would not combine any generating capacity. The Distribution Cooperatives' generating capacity is already combined in AECC.

Nevertheless, applying the DOJ/FTC Horizontal Merger Guidelines, the market power study found that the ESP would have a very small post merger market share, based on installed generating capacity, in the two geographic markets in which AECC has generation. The post merger HHI computation is well under the threshold of concern in both geographic markets.

The market power study concludes that the creation of the ESP by the Distribution Cooperatives would be procompetitive. Further, the study actually understates the geographic markets because of the expected creation of independent system operators and the elimination of multiple control areas and associated tariffs once competition begins.

Efficiencies

A business plan has been prepared to show the significant efficiencies created by the proposed ESP joint venture. This plan shows that the formation of the ESP, marketing state-wide, would result in a slight increase over current product costs. However, if the Distribution Cooperatives were to market individually on a state-wide basis, each of them would experience a significant and prohibitive increase over current product costs. If the Distribution Cooperatives choose to market only on a regional basis, concentrating on their traditional territories, the expected increase in product costs would be of sufficient magnitude to prevent them from effectively competing in the competitive retail market.

The business plan shows that the economies of scope and scale created by the integration of the various business functions in a single ESP are necessary to allow the individual Distribution Cooperatives to compete effectively. In fact, due to the significant costs of creating an efficient competitor, as illustrated in the business plan, the Distribution Cooperatives would not be effective or long-term participants in the retail market without the ESP. Furthermore, without the ESP joint venture most of the Distribution Cooperatives would not be participants in the competitive retail market at all.

Distribution of ESP Income through Payment of Patronage Dividends by Distribution Cooperatives

Consistent with their cooperative structure, the Distribution Cooperatives intend to distribute all of the income earned on the retail sale of electricity through the ESP to the retail consumers who gave rise to such income through the payment of patronage dividends, thus operating the ESP at cost. The ESP is being formed as a limited liability company and treated as a partnership for

Federal income tax purposes, in order to create the flow-though taxation and patronage relationship necessary so that the Distribution Cooperatives will be able to distribute the ESP income as tax-deductible patronage dividends.

ESP First Stage Operations

In its initial stage of operation, the ESP will be preparing for retail competition. The ESP's initial business operations will be focused upon having a retail electricity marketer ready for competition by January 1, 2002. These activities will include (i) conducting market analysis as to the likely retail electricity market upon the effective date of retail competition; (ii) creating the management team and structure for the ESP; (iii) creating and training the sales force and back office support team; (iv) creating the marketing message and developing the products and pricing structures; and (v) making the initial marketing contacts for sales upon the effective date of retail competition.

Throughout the initial stage, the ESP will need (i) capital to fund the significant expenses (without any offsetting revenues) to create the ESP and fund its business operations and (ii) significant management guidance and attention. The Distribution Cooperatives have these two assets in AECC, their current electricity production and purchasing joint venture. Thus, the Distribution Cooperatives have decided that they may most efficiently operate the ESP through the first stage by having AECC form the ESP as a single member limited liability company, wholly-owned by AECC. Since the ESP will be operating at a loss during this initial stage, there is no need to provide for the payment of patronage dividends by AECC, since patronage dividends are only paid on any profit earned on business done by the cooperative with or for the consumer. Instead, all of the net loss incurred by the ESP will be borne directly by AECC, although economically it is really borne by the Distribution Cooperatives due to their ownership of AECC.

ESP Second Stage Operations

In order to return profits to the consumers and minimize Federal income taxation, the Distribution Cooperatives will implement the second stage of the ESP joint venture. The basic purpose of the structure of the second stage will be to operate at cost with respect to each retail consumer by annually distributing to each such consumer through the payment of patronage dividends all of the net income realized within the cooperative system through the sale of electricity to the retail consumers who gave rise to such income. In order to accomplish this distribution of income on a tax efficient basis, the ESP must be structured as a partnership for Federal income tax purposes, with the net income from the ESP ultimately flowing through the Distribution Cooperatives, so that the Distribution Cooperatives may distribute all of the income earned throughout the cooperative system to the retail consumers who gave rise to such income, whether such customers are served directly by the Distribution Cooperatives (in the case of default customers) or indirectly through the ESP.

Distribution of ESP Income

The ESP income will be distributed between the common ownership interests held by the Distribution Cooperatives and the preferred ownership interest held by AECC. Although a portion of the ESP's income will be paid to AECC as a preferred distribution, AECC will then redistribute this amount to the Distribution Cooperatives as a patronage dividend, which the Distribution Cooperatives will take into account in determining their own patronage dividends to the retail consumers.

After the ESP's income is reduced by the AECC preferred distribution, all of the remaining income will be distributed to the Distribution Cooperatives. The proposed second stage structure will operate so that the distribution of the portion of the ESP income realized from sales to retail customers in traditional territories will be distributed to the respective Distribution Cooperative serving such territories. With respect to customers located outside traditional territories, the ESP income will be distributed proportionally to all of the Distribution Cooperatives.

To the extent that AECC realizes net income on the sale of electricity to the Distribution Cooperatives and the ESP, AECC is required by Arkansas law and under its bylaws to distribute such amount, as a patronage dividend, to such Distribution Cooperatives and the ESP based upon the volume or value of the respective business done by each of them with AECC. Thus, after taking into account the patronage dividend, AECC will sell its electric energy at cost to both the Distribution Cooperatives and the ESP. In addition, AECC is obligated to distribute as a patronage dividend to the Distribution Cooperatives the distribution received by AECC on its preferred ownership interest in the ESP.

The ESP will compute the net income earned on the sale of electrical energy to its retail consumers. The net income will include the profit earned on each particular sale, as well as the portion of the AECC patronage dividend received by the ESP attributable to the ESP's purchase of electricity to serve each such consumer. As described above, the portion of the net income earned by the ESP equal to the preferred distribution will be distributed to AECC, which AECC will then redistribute to the Distribution Cooperatives. The ESP annually will distribute the remaining net income to the Distribution Cooperatives for their distribution to the retail consumer, in accordance with the proposed distribution methodology.

The Distribution Cooperatives are required by Arkansas law and under their respective bylaws to distribute their net income to their member/consumers based upon the volume or value of the respective business done by such consumers with the Distribution Cooperatives. Each Distribution Cooperative will realize net income from (i) distribution and ancillary services; (ii) electricity sales to default customers (including the AECC patronage dividend on AECC's electricity sales to the Distribution Cooperatives); (iii) distributions by the ESP; and (iv) the patronage dividend from AECC attributable to its ESP preferred ownership interest. Each Distribution Cooperative will take the net income from these four sources and pay a patronage dividend to its consumers who gave rise to such income.

Thus, the proposed structure will enable electricity to be provided to each retail consumer through the system at cost by distributing the income realized within the cooperative system to the retail consumer who gave rise to such income.

Safeguards

The Act mandates that the PSC adopt detailed affiliate rules to ensure that all transactions between a utility's regulated and unregulated divisions, components or affiliates are not anticompetitive and are conducted at arm's length. The affiliate rules were adopted by the PSC on June 9, 2000. The affiliate rules generally require physical and functional separation between the regulated and affiliated unregulated operations to ensure that the unregulated affiliate does not have a competitive advantage over any other energy service provider, due to the relationship with the regulated utility. The affiliate rules are also designed to ensure that the electric utilities not use any revenues from any regulated asset, operation or service to subsidize the provision of any affiliated unregulated electric service or other unregulated activity.

The Act also grants the PSC extensive authority to monitor the developing competitive market and to make adjustments once market power is found. These mitigation measures include price caps, transactional standard offers, the auction of generation to be sold under long-term power contracts, the placement of assets or activities in affiliated corporations, and divestiture of assets or activities.[3]

The Act and the affiliate rules offer important protections from anticompetitive conduct in the market. Additionally, the ESP will adopt codes of conduct and an antitrust compliance program to ensure that its officers, directors and employees understand and follow the law.

Conclusion

Based on the foregoing, we respectfully request the Antitrust Division to provide a business review letter indicating that it has no present intention of taking enforcement action with respect to the Distribution Cooperatives' proposed

[3] See § 23-19-404(b) of the Act.

joint venture, the ESP. The ESP will provide an efficient competitor and a source of low-cost energy that would not otherwise be available to consumers in Arkansas. The ESP joint venture lacks market power and will adopt the various safeguards described herein. The creation of the ESP is procompetitive.

We appreciate your consideration of this matter, and we will provide any additional information that you require in assessing the Distribution Cooperatives' proposed ESP.

Sincerely,

STEVEN NAPPER, LTD.

Steve Napper