United States General Accounting Office

GAO

Report to the Honorable Bill Grant
House of Representatives

December 1988

PATRONAGE REFUNDS

Rural Telephone Bank's and Other Cooperatives' Methods to Refund Earnings

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GAO

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December 30, 1988

The Honorable Bill Grant
House of Representatives

Dear Mr. Grant:

As a follow-up to our July 23, 1987, testimony before the House Subcommittee on Government Information, Justice and Agriculture, you asked for our opinion on whether the Rural Electrification Act specifies a method the Rural Telephone Bank (RTB) must use to refund any earnings to its class B stockholders. We also agreed to provide information on the methods used by the Banks for Cooperatives to refund patronage capital obtained through the accumulation of earnings.

Based on our review of the Rural Electrification Act and RTB bylaws, we have concluded that patronage refunds, representing annual earnings after payment of cash dividends to class A and C stock, may only be distributed in the form of additional class B stock. In our opinion, unless the Congress amends RTB's authorizing legislation, no authority exists for RTB to pay cash dividends to class B stockholders, and no class B stock can be redeemed for cash prior to the redemption of all government-owned class A stock.

We obtained information from the Banks for Cooperatives and eight other cooperatives on their methods of refunding patronage capital under their governing legislation or cooperative bylaws. Their prevalent practice is to issue cash refunds, over a period of 1 to 15 years after the year net income is earned, based on the percentage of the interest that each stockholder/borrower paid during the period when the earnings were accumulated. We did not perform an in-depth study or attempt to determine the extent to which the nine cooperatives were comparable in operations to RTB.

Objective, Scope, and Methodology

The objective of our review was to determine whether the Rural Electrification Act of 1936, as amended (7 U.S.C. 901-950b), specifies a method that the Rural Telephone Bank must use to refund any earnings to its class B stockholders. In conducting our work, we reviewed the legislative requirements of the act and RTB's bylaws. We met with RTB's Assistant Governor and Assistant Treasurer to discuss RTB's patronage refund system. We also reviewed an RTB proposal (along with its documentation) which would have amended its bylaws to permit RTB to redeem its class B stock for cash. In addition, we contacted officials of the Banks for Cooperatives who referred us to several other cooperatives. We obtained data on the methods used to refund patronage capital for a total of nine cooperatives.

Background

In 1971, the Congress created RTB as a corporate instrumentality of the United States to meet the growing capital needs of rural telephone systems. RTB also is an agency subject to the supervision of the Secretary of Agriculture and the Government Corporation Control Act until such time as it redeems the majority of its stock owned by the United States. RTB's program objective is to obtain funds through the sale of stock and debentures to supplement the Rural Electrification Administration's (REA) telephone loan program and to make loans to providers of telephone service in rural areas. These providers have either received REA loans or loan commitments or have been certified eligible for such loans by the Administrator of REA.

The act provides for three classes of stock: A, B, and C. Class A stock may only be held by the Administrator of REA, on behalf of the United States. The act, as amended, provides that the United States purchase $600 million of class A stock through an annual appropriation of $30 million. Class B stock may be issued only to RTB's borrowers. Borrowers are required to purchase class B stock in amounts equal to 5 percent of any loan obtained from RTB. Class C stock may be issued to borrowers who wish to invest additional amounts in RTB.

Refunding Accumulated Earnings of RTB

Section 406(g) of the Rural Electrification Act stipulates that RTB's annual earnings remaining after payment of operating expenses and dividends on class A and class C stock, and setting aside reserves for losses, be set aside for patronage refunds. Consistent with section 406(d) of the act, RTB's bylaws call for patronage refunds to be distributed annually to holders of class B stock in the form of additional shares of class B stock.

RTB's staff had proposed amending section 8.2 of RTB's bylaws to permit periodic redemption of class B stock for cash prior to the retirement of all class A stock. That bylaw provides for RTB's board of directors to determine the procedures for retiring class B stock, but requires that all class A stock be retired first. Section 406(c) of the Rural Electrification Act provides that class A stock be retired starting October 1, 1995, and that the process be completed as soon as practicable. The minimum amount of class A stock to be retired each year is to equal the amount of class B stock sold by RTB during the year. The Office of General Counsel for the Department of Agriculture had advised RTB that the proposed bylaw amendment would be appropriate based on, among other provisions, section 405(g) of the Rural Electrification Act. That section of the act authorizes RTB's board of directors to establish bylaws, not inconsistent with law, to regulate the manner in which the bank's business is to be conducted. RTB's board of directors considered but did not adopt the proposed bylaw amendment.

Proposals for retiring class B stock similar to the one presented by RTB's staff could be considered in the future. We therefore examined the legal issues which that proposal raised. Based on our review, we have concluded that RTB may not pay patronage refunds on class B stock in cash in lieu of paying stock refunds. Redeeming class B stock for cash is not authorized by RTB's enabling legislation, which expressly provides under section 406(d) of the act that RTB earnings are payable to class B stockholders only in the form of stock patronage refunds. In addition, redemption of class B stock before the redemption of class A stock could impair the vested rights of prior redemption of the class A stockholder—the U.S. government. Accordingly, we believe that authority to redeem any class B stock for cash before redeeming class A stock must be specifically authorized by congressional action amending RTB's authorizing legislation.

Methods Other Cooperatives Use to Refund Patronage Capital

We contacted the Banks for Cooperatives and eight other member-owned cooperatives to find out how they refund earnings to stockholders. Each organization is subject to legislation or bylaws which govern the method by which patronage refunds are made. Although some issue stock dividends, the most prevalent practice is to issue cash refunds over periods ranging from 1 to 15 years after the year net income is earned. Refunds are distributed according to various measures of participation, but they are generally calculated based on the percentage of interest that each stockholder paid during the period when the earnings were accumulated. We did not perform an in-depth study to determine whether these cooperatives are adequately capitalized, to what extent they are responsive to their members' needs, or to what extent they are comparable to the operations of RTB. Additional details on each cooperative contacted are presented in appendix I.

As you are aware, section 1413(a) of the Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203) requires that all amounts in the reserve for contingencies be transferred to a reserve for losses due to interest rate fluctuations and that the new reserve be used only to cover operating losses. Section 1413(b) requires GAO to study the operations of RTB and make recommendations concerning the appropriate level of funding for its reserve for losses due to interest rate fluctuations and the disposition of any excess reserves. The results of our review of the RTB staff's proposed bylaw amendment for refunding earnings to class B stockholders have also been considered in that study. You will receive a copy of the final report on that study as soon as it becomes available.

A copy of this report will be sent to the Governor of RTB and will be made available to others upon request. Please contact Mr. Robert W. Gramling, Associate Director, at (202) 275-9406 if you or your staff have any questions concerning this report.

Sincerely yours,

Frederick D. Wolf
Director

Methods of Redeeming Patronage Refunds

We contacted officials of the Banks for Cooperatives, and they referred us to several other cooperative institutions. We obtained information from these institutions on the methods used to redeem patronage refunds (dividends). Officials of these institutions also referred us to other cooperative institutions. We specifically inquired of nine institutions contacted whether their redemptions are paid in cash or stock, over what period of time the redemptions occur, and how the amounts to be paid to each stockholder are determined.

The Banks for Cooperatives operate under the Farm Credit System and consist of 12 district banks and 1 central bank. The banks conduct business with organizations financed by the REA and farmer co-ops. As a condition of membership, the Banks for Cooperatives require a $100 purchase of class C stock. The Banks for Cooperatives generally issue patronage refunds annually in the form of at least 20 percent cash (though often there is a higher percent of cash) and 80 percent class C stock, based on the percentage that each member's interest payments comprise of the Banks' gross interest receipts.

The National Rural Utilities Cooperative Finance Corporation (CFC) is a nonprofit cooperative financing institution owned by its 966 member systems. CFC provides patronage capital refund checks to member borrowers on a 6-year cycle proportionate to interest paid on outstanding loans.

The National Consumer Cooperative Bank (NCCB) is a profit-oriented corporation which assists a variety of cooperatives in the housing, retail/wholesale, food, and health care industries. NCCB annually refunds 20 percent cash and 80 percent class B-2 stock to its members. A majority of members receive refunds based on the proportional share of interest paid. For those loans that have been sold to the secondary loan market, patronage refunds are based on unpaid loan balances at the end of the year.

The Rural Electric Cooperative Association (REA)[1] serves approximately 900 REA cooperatives. Members pay a $5 membership fee, which is recorded in an equity account and refunded upon termination of membership. The REA issues patronage refunds based on one of two methods: (1) amounts paid in 15 years ago or (2) the percentage method, which is based on a proportion of the member's usage of the cooperatives' services.

[1]This cooperative association refers to itself as REA.

Buggs Island Telephone Cooperative provides rural telephone service to 1,950 members. To join the cooperative, members pay a $10 membership fee, which is recorded in an equity account and refunded upon termination of telephone service. Patronage refunds are made on a 15-year rotating schedule. Those individuals who became members 15 years ago are currently receiving cash refunds based on their total phone bills for that particular year. During the interim 15-year period, the retained profits are used for operating capital.

South Plains Telephone Cooperative provides rural telephone service to 3,500 members. Members pay a $5 membership fee, which is recorded in an equity account and refunded at the time membership is relinquished. The cash patronage refund which members receive annually is a percentage of an individual member's payments for services to the total service payments of the cooperative.

Sully Buttes Telephone Cooperative provides rural telephone service to its members but does not impose a membership fee. The cooperative, currently operating at a loss, intends to carry its losses forward as an offset against future profitable years. Therefore, it does not expect to issue patronage refunds in the near future.

Garden Valley Telephone Company is a nonprofit organization that provides telephone service to 13,000 subscribers. It has neither a membership fee nor stock purchase requirements as conditions for membership. The company annually issues a cash patronage refund based on the percentage that individual members paid for telephone service during that year.

The Telecommunications Cooperative Network charges a $100 membership fee, which is refundable upon termination of membership. The network annually issues checks for patronage refunds to members based on their commissions earned for selling network services for the preceding year.

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