



United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-258095

August 12, 1994

The Honorable Mike Synar
House of Representatives

Dear Mr. Synar:

This letter responds to your request that we review the investment activities of the Verdigris Valley Electric Cooperative, Inc. (VVEC), an electric utility located in Collinsville, Oklahoma. VVEC is a borrower of the U.S. Department of Agriculture's Rural Electrification Administration (REA). REA provides loans and guarantees to rural electric utilities, almost all of which are cooperatives, to finance rural electric systems and economic development projects. Amendments enacted in 1987 to the Rural Electrification Act of 1936 encouraged electric cooperatives to support rural economic development. These amendments authorize REA's borrowers to make investments, loans, and guarantees of up to 15 percent of the value of their total utility plant¹ without restrictions or the prior approval of REA's Administrator. To aid in rural community development, cooperatives can invest in, among other things, water/waste systems, garbage collection, and job creation.

You asked us to examine allegations of improper investment practices by VVEC or its subsidiary, the Verdigris Valley Economic Development Corporation (Development Corporation). As agreed with your office, we obtained information on VVEC and the Development Corporation, which provided loans and guarantees to Precision Tubulars, Inc. (Precision).²

¹REA's guidance defines "total utility plant" as the value of the total utility plant in service and the construction work in progress.

²Precision was a pipe resizing business that employed the process of cold drawing. The process consists of pulling a pipe through a metal cylinder that has a smaller diameter than the pipe; as a result, the pipe is resized.

Specifically, we developed information on funds invested in Precision, which filed for bankruptcy in April 1991; tax liens and lawsuits involving Precision; the Oklahoma Corporation Commission's activities related to VVEC; and VVEC's compliance with REA's regulations on investments. At your request, we also developed a chronology of the major events concerning Precision, which is included as an enclosure to this correspondence.

In summary, we found that VVEC invested about \$5.2 million in Precision. Others, such as the National Rural Utilities Cooperative Finance Corporation³ and sources at the city and county level, loaned over \$2 million. We found two tax liens and one lawsuit that had been filed against Precision and its president. The Oklahoma Corporation Commission has reviewed VVEC twice since Precision went into bankruptcy, finding no problems with VVEC's electric rates or accounting procedures. We found no indication that VVEC attempted to circumvent REA's investment regulations. However, REA and VVEC both told us that, during the time the loans were made to Precision, there was confusion about how to apply the regulations on investment limits.

Proposal Development and Funding for Precision

According to the former general manager and the current office director of VVEC, another REA cooperative, the KAMO Electric Cooperative, Inc.,⁴ introduced both the proposal to invest in Precision and the company's president to VVEC. VVEC's former general manager said that KAMO's economic development officer briefed him on the Precision proposal in March 1989, describing it as a "great project." He also told us that KAMO and other entities were willing to commit over \$2 million to the project and that he believed the project could yield about 200 jobs. In addition, the Oklahoma Department of Commerce endorsed the project. A June 1989 memorandum from the Oklahoma Department of Commerce to KAMO states that a credit report on both the president of Precision and his other company, Service Steel Co., Inc. (Service Steel), was complete and positive with no late payments reflected in the previous 20 years of

³The National Rural Utilities Cooperative Finance Corporation is a financial institution that lends money to members to finance utility and nonutility projects.

⁴KAMO is a power generation and transmission cooperative that sells electricity to VVEC.

reporting. The memorandum describes the Precision proposal as "strong and viable." VVEC's former general manager also told us that KAMO's economic development officer presented the project to VVEC's Board of Directors and that the board decided to invest in Precision because of the support for the proposal. VVEC then formed the Development Corporation as a subsidiary to handle its investment in Precision, according to VVEC's former private counsel.

Through a review of financial ledgers, loan agreements, and promissory notes and through discussions with VVEC's office director and current private counsel, we compiled the following information on the funding provided through loans to Precision:

City of Bartlesville, Oklahoma	\$ 200,000
Washington County (Okla.) Industrial Authority	500,000
National Rural Utilities Cooperative Finance Corporation (VVEC guaranteed \$1,025,000; KAMO guaranteed \$512,000)	1,537,500
Verdigris Valley Economic Development Corporation	<u>5,249,827</u>
Total	\$7,487,327

After Precision declared bankruptcy, in July 1994 the court granted VVEC its Motion for Judgment by Default, the right to pursue collection of about \$7.3 million plus interest, court costs, and an attorney's fee because the defendant, the president of Precision, failed to answer VVEC's lawsuit against him.

Tax Liens and Lawsuits Related to Precision

We found two federal tax liens that had been filed against Precision and its president for nonpayment of payroll taxes. The first lien, for about \$30,000, was filed in May 1989--before the first promissory note from Precision to the Development Corporation was executed in September 1989. The second lien, for about \$32,000, was filed in October 1989. VVEC officials told us that they were not aware of any tax liens filed against the president of Precision during the time the loans to Precision were made. VVEC's former general manager and former counsel also stated they had no knowledge of the federal tax liens until after Precision filed for bankruptcy in April 1991. Also, Service Steel, in which Precision's president was listed as a one-third owner, petitioned for bankruptcy in July 1990--after the Development Corporation committed loan funds to Precision.

We also found one lawsuit that VVEC had filed. As noted above, VVEC filed a Motion for Judgment by Default against the president of Precision, and in July 1994 the court ruled in favor of VVEC for over \$7.3 million.

Oklahoma Corporation Commission's Activities

The Oklahoma Corporation Commission oversees both the quality of electric service provided by electric cooperatives and the rates they charge. To monitor cooperatives' activities, the commission is to conduct audits or reviews of the electric cooperatives under its jurisdiction every 5 years. According to an official of the commission, the commission did not issue a report about its review of VVEC, which it conducted in either April or May 1993, but found no problems with VVEC's electric rates. According to this official, as of July 31, 1993, VVEC had written off the Precision loss on its books.⁵ The official explained that the Development Corporation does not fall under the commission's jurisdiction "as it conducts non-utility activities as a nonregulated subsidiary." However, the commission official stated that writing off the loan to Precision could potentially (1) affect VVEC's electric rates or (2) result in assessments being made against the cooperative's members. Another commission official told us that the commission visited VVEC again in June 1994 and reviewed its accounting procedures, which it found to be in order.

REA's Regulations on Investments

VVEC officials stated that REA's guidance was unclear about what should be included as an investment under the rule allowing electric borrowers to make investments of up to 15 percent of the value of their total utility plant without REA's prior approval. VVEC officials and minutes from board meetings of VVEC and/or the Development Corporation indicate, however, that REA's field representative visited VVEC to discuss the 15-percent rule. A field report on VVEC dated August 1990 states, "it appears the borrower has investments in excess of 15 percent." In November 1990, REA notified VVEC's Board of Directors that VVEC's investments exceeded the 15-percent limit. VVEC officials then visited REA headquarters in March 1991 to discuss the rule, according to VVEC documents. REA field reports dated March

⁵According to VVEC's current private counsel, VVEC's total loss attributable to Precision is about \$6.7 million.

and April 1991 indicate that VVEC's investments were under the 15-percent limit, but a financial review of VVEC's accounts conducted by REA in May 1991 determined that the cooperative's investments were above the 15-percent limit. A VVEC official told us that the cooperative did not receive written instructions on the 15-percent rule until February 1992--the month after it sold one of its subsidiaries to bring its nonutility investments within the 15-percent cap. We found no indication that VVEC attempted to circumvent REA's investment regulations. However, REA and VVEC both told us that, during the time the loans were made to Precision, there was confusion about how to apply the regulations on investment limits.

With regard to the 15-percent rule, REA headquarters officials told us that REA issued final regulations on the rule in June 1989 and sent copies to each of its electric cooperative borrowers in July 1989. These officials told us, however, that some cooperatives, such as VVEC, initially had difficulty interpreting the regulations. REA issued an instruction to clarify the subject dated December 1991 and bulletins to further clarify the regulation dated December 1993. Although the REA officials now believe that the guidance is adequate, an REA headquarters task force is reviewing the investment regulations. Among the issues the task force is considering are (1) the propriety of excluding certain nonutility investments from the 15-percent calculation, as REA currently authorizes--an issue raised by Agriculture's Office of Inspector General⁶--and (2) establishing criteria for REA to use in reviewing and approving investments that exceed the 15-percent limit. The task force is to provide its preliminary findings to REA's Administrator in August 1994.

We limited our review to interviews with current and former officials and attorneys of VVEC, officials of the Oklahoma Corporation Commission, and officials at REA headquarters. We also reviewed documents obtained from VVEC and its private counsel, the Oklahoma Department of Commerce, the Rogers County (Oklahoma) Courthouse, and REA headquarters. We did not perform a financial audit of VVEC's accounts. We met with officials in REA's headquarters, including the Deputy Administrator for Program Operations and the

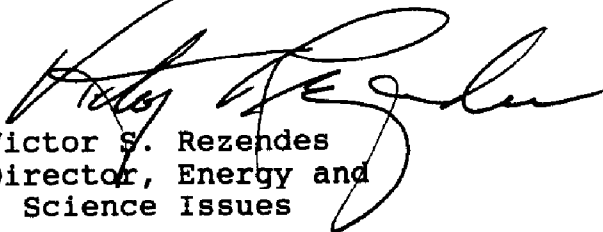
⁶Evaluation of Electric Generators and Distribution Borrower Investments, USDA/OIG-A/09600-2-Te (June 8, 1994).

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Assistant Administrator for Electric Operations, to discuss the contents of this correspondence. They agreed with the information presented.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this correspondence until 30 days after its date. At that time, we will send a copy to the REA Administrator. We will also make copies available to others on request. If you have any further questions concerning this correspondence, please call me at (202) 512-3841.

Sincerely yours,



Victor S. Rezendes
Director, Energy and
Science Issues

Enclosure

CHRONOLOGY OF VVEC'S RELATIONSHIP WITH PRECISION

- 05/30/89 Federal tax lien for payroll taxes is filed at the Rogers County Courthouse against Precision and its president for \$30,392.87. The lien was released on December 5, 1990, after the taxes were paid.
- 06/08/89 Memorandum from a finance specialist, Capital Resource Division, Oklahoma Department of Commerce, to the economic development officer at KAMO, regarding a credit report, résumé, and reference verification, indicates a clear record for Service Steel, Precision, and Precision's president.
- 09/20/89 Promissory note is provided to the Development Corporation from Precision for \$200,000.
- 10/23/89 Federal tax lien for payroll taxes is filed at the Rogers County Courthouse against Precision and its president for \$32,174.26. The lien was released on January 2, 1990, after the taxes were paid.
- 12/20/89 Second promissory note is provided to the Development Corporation from Precision for \$255,000 (cumulative).
- 01/31/90 Third promissory note is provided to the Development Corporation from Precision for \$3 million (cumulative).
- 03/23/90 Oklahoma Department of Commerce approves Washington County's request under the Community Development Block Grant program for a \$500,000 loan to Precision.
- 04/16/90 City of Bartlesville agrees to provide \$200,000 to move Precision's operation to Dewey, Okla.
- 05/29/90 Precision sends letter to VVEC's manager explaining cost overruns.
- 06/06/90 Precision sends letter to VVEC's manager explaining higher costs related to equipment.
- 06/30/90 Promissory note is provided to the Development Corporation from Precision for the total (cumulative) amount of the loan, \$6,787,326.87.

ENCLOSURE

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07/31/90 Service Steel (Precision's president was a one-third owner) files for voluntary bankruptcy.

11/30/90 REA notifies VVEC's Board of Directors that VVEC is in violation of the 15-percent rule.

03/03/91 VVEC board members travel to Washington, D.C., to discuss the 15-percent rule with REA.

04/09/91 Development Corporation's Board of Directors is notified that Precision has given lay-off notices to its employees.

04/25/91 Precision files for bankruptcy in U.S. Bankruptcy Court, Northern District of Oklahoma.

05/91 REA audits VVEC for compliance with the 15-percent rule.

1/09/92 VVEC sells its satellite TV subsidiary to bring its nonutility investments within the 15-percent cap.

02/92 VVEC reportedly receives the first paper documentation on REA's 15-percent rule.

02/02/94 VVEC sues Precision's president to recover losses attributed to loans and guarantees related to Precision.

06/15/94 An official of the Oklahoma Corporation Commission advises GAO that the commission reviewed VVEC's electric rates in either late April or early May 1993 and found no problems.

07/07/94 Judgment by Default granted in favor of VVEC in Tulsa County (Oklahoma) District Court for the amount of \$7,287,326.87 plus interest, court costs, and an attorney's fee of \$3,000.

08/04/94 An official of the Oklahoma Corporation Commission advises GAO that the commission reviewed VVEC's accounting procedures in June 1994 and found them to be in order.

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