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STATEMENT OF

JOHN LUKE, ASSOCIATE DIRECTOR

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
SENATE SUBCOMMITTEE ON AGRICULTURAL CREDIT AND RURAL
ELECTRIFICATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
ON
THE INTEGRITY OF THE RURAL ELECTRIFICATION
AND TELEPHONE REVOLVING FUND

Madam Chairman and Members of the Subcommittee:

We are here today to discuss our ongoing review of the integrity of the Rural Electrification and Telephone Revolving Fund, which is administered by the Rural Electrification Administration (REA). As a part of our review, you requested that we look into:

--the size of subsidies being provided to investor-owned utilities (IOU's), public utilities, and rural electric cooperatives (REC's),

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- the effect of these subsidies on utility rates,
- the extent to which subsidies on REA loans have resulted in an unfunded liability in the revolving fund,
- the impact of Senate bill S. 1300 on balancing the fund, and
- the options or other matters the Congress should consider in its deliberation of S. 1300.

In summary, we found that REC's receive loan subsidies that are 2.4 times greater than the tax benefits received by IOU's. These loan subsidies help to reduce REC electric rates by about 7 percent whereas the tax benefits IOU's receive reduce electric rates by only about 3 percent. REA loan subsidies have not yet produced an unfunded liability in the revolving fund but such a liability will begin to accrue in the fund in about 3.5 years at present loan and subsidy levels.

S. 1300 would attempt to make the fund self-sufficient by changing loan interest rates, capitalizing the funds' Treasury debts, and authorizing the fund to refinance its debts with the Federal Financing Bank when interest rates are falling. But these actions will not be adequate under present conditions to make the fund self-sufficient.

More importantly, the interest rate provisions in S. 1300 would continue federal subsidies to REC's regardless of financial need and/or the rural/urban constituency of the consumers they serve. Rather than set loan interest rates to make the fund self-sufficient, the Congress should reexamine the program's objectives and the criteria being used to determine the level of assistance needed and the intended beneficiaries. Any subsidies resulting from this could be appropriated. This would provide a better perspective of the cost of REA's programs and ensure the continued operation of the revolving fund.

The permanent capitalization of the fund's \$7.9 billion in debts to the Treasury is questionable considering that the fund is now capable of repaying this debt. Further, this action would take place outside the budget/appropriation process and as such, it represents a form of "backdoor" financing. If this action is truly needed, then the Congress should consider using the budget/appropriation process to accomplish this.

Regardless of whether appropriations are used to capitalize the fund's Treasury debts or fund loan subsidies, the Congress should consider bringing the activities of the revolving fund back on-budget.

Besides allowing the fund to refinance its debts with the Federal Financing Bank, S. 1300 also would allow REC's to refinance, when interest rates are falling, REA guaranteed loans financed by the Bank. Because only downward adjustments would be made in interest rates under these provisions, this one-sided approach would shift some of the risk of financing to the government and possibly result in unnecessary losses. To preclude this, the Congress may wish to provide for an adjustable or variable loan interest rate.

BACKGROUND

The Rural Electrification and Telephone Revolving Fund was established in 1973 to facilitate the financing of REA loans to REC's and telephone companies or cooperatives serving rural areas. When the fund was established, all existing REA loans were placed in the fund, and the principal and interest collections on these loans were to be used to fund new loans. Because the loans placed into the fund had been financed from borrowings from the Department of the Treasury, the fund was required to repay these Treasury debts, which total \$7.9 billion. These debts are scheduled for repayment between 1993 and 2016. However, the fund was relieved by law of having to pay any interest on these debts when it was established.

When the income to the fund is not large enough to meet loan advances on other obligations, the fund sells Certificates of Beneficial Ownership (CBO's) in the loans made and held by the fund. To date, all CBO's have been sold to the Federal Financing Bank (FFB), which is an agency within the Department of the Treasury. The FFB obtains its funds from the Treasury, which in turn sells notes and bonds on the open market. The fund pays interest on CBO's based on the cost the Treasury incurs in raising funds, hereafter referred to as the government's cost of borrowing, plus one-eighth of 1 percent.

For years, the fund has been borrowing from the FFB (selling them CBO's) at interest rates substantially higher than the interest rates charged on REA loans financed from the fund. As a result, REA now estimates that the fund's interest expenses will exceed interest income by about 1986 and that appropriations will be needed by 2002 if the fund is to continue to operate.

REA loans made from the fund generally bear interest at 5 percent; but the REA Administrator can also make loans at a special rate of 2 percent. These low 5- and 2-percent interest rate loans have been used generally to finance electric distribution facilities and telephone services. REA also guarantees loans made by third parties and the fund is responsible for any losses arising from these guarantees. Guaranteed loans bear interest at a rate agreed to by the borrower and lender. Most guaranteed loans, about 86 percent, have been made by the FFB at rates equal to the government's cost of borrowing plus one-eighth of 1 percent and most have been used to finance electric generation and transmission facilities. REA's direct and guaranteed loans are repayable with maturities up to 35 years.

Senate bill S. 1300 would attempt to balance the fund, that is, make it self sufficient by

--changing the basis for setting interest rates on REA loans, and

--reducing the fund's future cash payments by permanently capitalizing the fund's \$7.9 billion Treasury debt and authorizing the fund to refinance at reduced interest rates its borrowings from the Federal Financing Bank.

FEDERAL SUBSIDIES TO
ELECTRIC UTILITIES

IOU's, public utilities, and REC's all receive sizeable subsidies from the federal government. IOU's receive sizeable tax benefits, primarily in the form of tax deferral through accelerated depreciation and the investment tax credit, which offsets part or all of the income tax imposed on profit-making private corporations. IOU's also benefit from the deferral of federal income taxes on dividends that are reinvested in the IOU in the form of common stock. Other corporations besides IOU's are also eligible for these tax benefits, with the exception of dividend reinvestments. However, according to a November 29, 1982, Congressional Research Service report,¹ these tax benefits have rendered very large benefits to IOU's because of their extreme capital intensity; benefits that were enhanced through recent tax changes aimed at further shortening depreciation periods for public utility property. Public utilities are tax-exempt and are able to raise capital through the sale of bonds on which the interest income is tax exempt. REC's generally are also tax-exempt, in addition, they receive direct low-interest rate loans from REA.

Exhibit A shows our estimate of the federal income taxes that would be lost today in financing \$850 million in capital expenditures through (1) the tax benefits IOU's would receive from investment tax credits and accelerated depreciation and (2) the

¹Kiefer, Donald W., "Investor-Owned Electric Utilities versus Rural Electric Cooperatives: A Comparison of Tax and Financial Subsidies," Congressional Research Service, November 29, 1982.

issuance of tax-exempt bonds by public utilities. It compares these estimates to our estimate of the REA loan subsidies that would be provided through a comparable level of capital expenditures by REC's. We used \$850 million in capital expenditures because this represents the current annual level of REA's direct loan program. Other assumptions used to prepare this exhibit are listed in appendix I.

As exhibit A shows, the subsidy cost of financing capital expenditures through REA's direct loans is now about 2.4 times the government's cost (taxes lost) in financing an equal amount of capital expenditures for IOU's. Further these direct loan subsidies enable REC's to lower the electric rates charged their consumers. We estimate that REA's 5-percent interest rate loans today work to reduce consumer electric rates by almost 7 percent. In comparison, Don Kiefer of the Congressional Research Service² has determined that the tax benefits provided to IOU's have reduced IOU electric rates by only about 3 percent.

REC's receive other benefits besides loan subsidies that help to further reduce the electric rates REC's must charge their customers but which were not considered in preparing exhibit A. As previously noted, REC's are generally exempt from paying federal income taxes. We discussed this issue in our January 1983 report to the Congress on "Legislation Needed to Improve Administration of Tax Exempt Provisions for Electric Cooperatives" (GAO/GGD-83-7, Jan. 5, 1983). Specifically, we reported on how the operations of many REC's and the environment in which they do business have changed substantially since the time they were granted tax exemption. In view of these changed conditions, we reported on how the Internal Revenue Service needed to make administrative changes to better enforce the existing tax

²Kiefer, Donald W., "The Impact of the Economic Recovery Tax Act of 1981 on the Public Utility Industry," Congressional Research Service, Report No. 82-6E, January 15, 1981, App. II.

exemption provisions. More importantly, we recommended that the Congress adopt a tax treatment which better recognizes changes in some electric cooperatives. A summary of our report is included in appendix II.

The benefits REC's derive from tax exemption together with REA loan subsidies were compared to the tax benefits IOU's receive in a November 29, 1982, Congressional Research Service report.³ Rather than calculate the dollar amount of subsidy, this study estimated the reduction in utility rates charged to customers. The study considered this to be a more appropriate way to measure and compare subsidies because price response determines the economic effects of the subsidies. In looking at subsidies in this manner, the study concluded that in comparison to a fully taxable, nonsubsidized firm, REC's were currently receiving larger subsidies from the federal government through tax-exemption and loan subsidies than IOU's received through investment tax credits and accelerated depreciation. Further, the study indicated that this conclusion would not be so clear if loan subsidies were eliminated in which case the issue of who was receiving the greater subsidy would depend on the discount rate used in the analysis.

Besides their tax-exemption and REA loan subsidies, REC's receive other benefits not otherwise shared by IOU's which could further reduce their electric utility rates. For example, REC's and likewise public utilities can purchase power from federal agencies on a preferential basis. REC's also do not pay any fees to cover REA's expenses in administering the electric loan program nor pay interest (rate of return) on their capital.

³See footnote 1.

Before moving on to the revolving fund, we should point out that telephone companies and cooperatives also receive REA's low interest rate loans. Based on present loan levels, about \$250 million annually, the amount of subsidies being provided to telephone companies and cooperatives is now about \$119 million (present value) annually. In addition, REA-assisted telephone companies also benefit from the same tax benefits being provided to IOU's--investment tax credits and accelerated depreciation.

IMPACT OF SUBSIDIES ON
THE REVOLVING FUND

To determine the impact of subsidies on the revolving fund, we obtained, using REA's computer model of the fund, a report on the fund's future receipts and payments assuming REA's programs were allowed to lapse at the end of fiscal year 1983. We then discounted these receipts and payments to their present value based on the government's cost of borrowing. At this point, we should point out that we have reviewed REA's computer model and believe it provides a reasonable estimate of the outcomes that can be expected based on the assumptions used. The results of our analysis, which are shown in exhibit B, provide a status report of the fund.

As exhibit B shows, the funds \$8.6 billion in receipts (present value) is adequate to cover all payments, including the repayment of \$7.9 billion in Treasury debt, which now has a present value of \$1 billion. In fact, after all payments are made, the fund will have excess receipts of \$1.6 billion (present value), which is in effect the remaining (unused) equity of the fund. Considering the net equity now in the fund, the fund has not yet incurred an unfunded liability.

Although the fund is now sound, that is it has a net equity of \$1.6 billion, exhibit B shows that REA loans financed through the fund have cost the taxpayers \$8.2 billion. This is because

the fund's net equity is insufficient to cover the interest that the Treasury will have to absorb through the waiver of interest on the fund's \$7.9 billion in Treasury debt. Based on the government's cost of borrowing when these Treasury debts were incurred, we estimated that the present value of this forgiven interest is \$9.8 billion.

Based on the fund's \$1.6 billion in net equity, we estimate that the fund can operate for about 3.5 more years at current funding and subsidy levels at which time the fund's net equity will be exhausted. Without some form of relief, the continued operation of REA's programs beyond 3.5 years would result in a deficit (unfunded liability) in the fund.

INTEREST RATES UNDER S. 1300

S. 1300 would eliminate the existing fixed 5 percent interest rate for REA's direct (insured) loans. Instead, under section 6(1) of the bill, the standard interest rate would be set at a rate, but not less than 5 percent, that would produce interest income equal to the amount of anticipated interest expense on the account's obligations (debt) required to be issued or sold during such period to cover loan advances and interest expenses. Under section 6(1), the account's obligations would be determined by deducting the sum of principal and interest receipts and any appropriations made pursuant to section 6(3) from the sum of loan advances and interest expense on outstanding obligations. Exhibit C illustrates how this formula would be used to set the standard rate.

According to REA, the interest rates derived from this formula will not be sufficient to balance the fund, that is make it self-sufficient, under conditions in effect today. This would be the case even if action was taken to reduce the fund's cash outlays by (1) permanently capitalizing the fund's Treasury debt as provided for in section 4 of the bill and/or (2) authorizing

the fund to refinance CBO's when the rates on new CBO's dropped by at least 1 percentage point as in section 5 of the bill.

We agree with REA's assessment. REA interprets the formula the same as we do. In addition, we reviewed REA's application of this formula, including its computer program, and believe the rates REA computed provide a reasonable estimate of the rates that could be expected under the formula. The formula does not work in most situations because the interest rates derived from the formula do not generate sufficient interest income to cover interest expenses. In addition, the formula makes no provisions for retiring the fund's outstanding CBO's. As a result, the fund has to sell larger amounts of CBO's than would otherwise be necessary and eventually, the loans available for CBO sales become exhausted, making appropriations necessary.

Exhibit D shows the rates REA expects from using this formula, with and without sections 4 and 5, assuming the government's cost of borrowing (CBO interest rate) remains at about 11 percent (the rate as of June 1983).

Regardless of the growth assumption used, as exhibit D shows, appropriations would be needed as early as 2005 or as late as 2016. Consequently, the interest rates derived from the section 6(1) formula will not be adequate to ensure the self-sufficiency of the revolving fund.

Using its computer model of the fund, REA estimated that an interest rate of about 8.4 percent would be needed to balance the fund assuming

--the government's cost of borrowing remains at 11 percent,

--program lending remains at the current level of about \$1.1 billion (no growth), and

--sections 4 and 5 of S. 1300 are not authorized.

In contrast, as exhibit D shows, the section 6(1) formula based on these same assumptions would result in an average interest rate of only 7.8 percent, a rate that is insufficient to balance the fund.

Besides not balancing the revolving fund, the formula rates would continue federal subsidies. This is because the formula presumes that loan receipts (those in excess of interest expenses) are assets of the fund and therefore carry a zero interest cost when they are reloaned. This presumption is recognized in the National Rural Electric Cooperative Association's January 1983 report on "Rural Electric Financing for the Future." Accordingly, the formula provides for deducting loan receipts from the sum of advances and interest expense to arrive at the accounts obligations as shown in exhibit C. However, loan receipts have a value to the government equal to the government cost of money. This is so because the reuse of these funds to make new loans deprives the government of the use of these funds; funds that the Treasury could use to reduce its borrowings. Moreover, as long as REA's loans carry rates less than the Government's cost of money, a federal subsidy will exist.

Based on the average interest rates to be paid under section 6(1) under the no growth scenario (see exhibit D), we estimate that the average federal subsidy will total \$287 million, \$314 million if sections 4 and 5 are also enacted, for each \$1.1 billion made in new loans. Similarly, if rates were set at the 8.4 percent rate deemed necessary by REA to balance the fund, the average federal subsidy would be more in the neighborhood of \$224 million for each \$1.1 billion in new loans. In contrast, the federal subsidy now totals \$523 million for each \$1.1 billion in new loans. Consequently, subsidy cost would be reduced substantially over present levels by either enacting section 6(1) or raising rates to the level needed to balance the fund.

NEED FOR SUBSIDIES

But are subsidies needed? More importantly, what should be the appropriate level of subsidy, if any, or the REA loan interest rate? To address this issue, we call your attention to our report on the "Rural Electrification Administration Loans to Electric Distribution Systems: Policy Changes Needed" (CED-80-52, May 30, 1980).

The report points out that many rural electric distribution systems appear financially sound and able to qualify for non-REA loans at reasonable rates and terms. For example, as of December 1978, 386 of the 922 REA distribution system borrowers, or about 42 percent, had a times interest earned ratio⁴ of 2.5 or more and an equity ratio⁵ of 30 percent or more, levels which would generally be sufficient to obtain financing from private creditors at reasonable rates and terms. Some of these borrowers have to charge relatively high electric rates to maintain financial soundness. Others, however, have low costs and could absorb increased interest costs and still charge electric rates comparable to those charged by neighboring investor-owned utilities. For example, based on an analysis of 14 borrowers, we reported that 4 could absorb increased interest costs without making any changes in electric rates whereas the remaining 10 would have had to increase residential electric rates by no more than 8.3 percent (\$3.59 per month per customer) based on projected average monthly usage. Although it appeared some borrowers could obtain all their financing from private sources without adversely affecting interest rates, the report stated that REA did not have criteria to determine which borrowers could qualify for private sector loans.

In response to your request, we updated this information. The results of this update are shown in exhibit E. As this

⁴A ratio showing the number of times net income covers interest expenses.

⁵Ratio of net worth to total assets.

exhibit shows, as of December 1981, 305 of the 921 electric distribution borrowers that reported equity levels to REA, or 33 percent, had an equity ratio of 30 percent or more and a times interest earned ratio of 2.5 or more. Further, 199 of the 305 distribution borrowers, or about 22 percent of all those reporting, had an equity ratio of 40 percent or more. The latter is important when you consider that as of December 1981, the average equity level for IOU's was 40 percent and their average times interest earned ratio was 2.3.

As exhibit E also shows, many of the financially sound REC's had electric rates that were below either the (1) National average IOU electric rate, (2) National average IOU residential electric rate, or (3) National average REC residential electric rate. I would emphasize that caution should be exercised in using this data because it does not consider regional variations.

For borrowers that do not have the financial strength to borrow from private credit sources, our report stated that REA needed to do more to encourage borrowers to become self-sufficient. Specifically, REA needs to establish minimum equity goals for borrowers, require borrowers to develop plans to achieve these goals, and in reviewing electric rate changes, ensure that rates are sufficient to meet the equity levels set forth in the plans.

In addition, the report pointed out that REA's loan making criteria does not adequately correlate the type and/or amount of subsidized loan REA will provide with the borrowers' needs. As a result, some borrowers that had high costs and high electric rates, received the same subsidy or even less than borrowers with low costs and rates. We concluded that REA needed new loan criteria to better correlate the type and amount of subsidized loan to the borrower's individual needs for assistance and we recommended that REA develop a legislative plan to revise its policies for making insured electric loans.

In addition, our report raised the issue as to whether rate comparability is an objective of the REA program. The Rural Electrification Act of 1936, as amended, does not directly set forth rate comparability with urban areas or IOU's as an objective of REA's electric programs. But we did offer evidence to show that rate comparability should be an objective of REA's electric program. In addition, we pointed out that the act's objective of providing central station electricity to rural persons, for all intents and purposes, has long been accomplished.

To date, no action has been taken on our report's recommendations.

In addition, we would like to call your attention to the Department of Agriculture, Office of Inspector General's May 20, 1983, audit report on "Loan Making Policies for Electric Distribution Cooperatives" (Audit Report No. 09613-1-CH). In that report, the Inspector General confirmed what we had found in our May 1980 report, namely that REC's were receiving REA assistance regardless of financial need. In addition, the Inspector General reported that REC's were still receiving REA assistance regardless of whether they were still serving rural areas. According to their report, REA and the Department of Agriculture's Office of General Counsel have interpreted the Rural Electrification Act and congressional directives to allow loans to REC's regardless of their financial strength or the urban/rural characteristics of their service areas. In addition, their report also stated that REA's operating procedures needed to be strengthened to ensure that loan funds are disbursed properly and used only for authorized purposes. A more detailed summary of the reports findings and recommendations is included in appendix III.

In light of the findings in these two reports, we urge the Congress in its deliberations of S. 1300 to reexamine and clarify the program's objectives as well as the criteria to be used to determine the level of assistance (subsidy) to be provided and the intended beneficiaries to accomplish the program's objectives.

REFINANCING LOANS

Section 7(4) of the bill would allow borrowers with REA guaranteed loans to refinance their loans, without penalty, when the rates paid on these loans exceed the rates for new loans by one percentage point or more. Loans would have to have a remaining term to maturity of at least 7 years to be eligible for refinancing and no loan could be refinanced more than once in any 7 year period. Similarly, section 5 would allow the fund to repurchase from the FFB, in effect refinance, its outstanding CBO's that have a remaining life of 7 years or more whenever the interest rate on these debts exceeds the rate applicable to new CBO's by 1 percentage point or more.

These sections would permit REC's and the fund to reduce their interest cost. For example, if section 5 were in effect in June 1983, the fund could have refinanced \$1.9 billion in CBO's, which were initially sold to the FFB at an average interest rate of 13.1 percent, for about 11 percent. We estimated that this refinancing would save the fund about \$328 million (present value) over the remaining life of these CBO's, thereby increasing the fund's capacity to operate further into the future. Additional refinancings would produce even greater savings.

Although REC's and the fund would realize savings through such refinancings, neither section 5 nor 7(4) provide for increasing interest rates when interest rates are rising. Therefore, this one-sided approach would shift some of the risk of financing to the government. This is because the government, through Treasury's public debt borrowings, is the ultimate source of funds for CBO's and REA guaranteed loans financed through the FFB. Further, as a result of this shift, the government could realize either a gain, thereby negating any savings realized through the refinancing of CBO's and REA guaranteed loans, or incur a loss. Such gains or losses are possible considering the overall short-term

nature of the government's borrowings, the frequency with which these debts are refinanced relative to the refinancing of CBO's and REA guaranteed loans, and the future movement of interest rates. To preclude such gains or losses, the Congress may wish to amend sections 5 and 7(4) to provide for charging an adjustable or variable interest rate to provide for upward as well as downward adjustments in interest rates.

CAPITALIZATION OF TREASURY DEBT

As shown in exhibit B, the fund is capable of repaying its \$7.9 billion in debts to the Treasury. Yet, section 4 of the bill would permanently capitalize this debt as equity in the revolving fund.

The capitalization of Treasury debt would inject the fund with additional financial resources, thereby enabling the fund to reduce its CBO sales and in turn its interest expenses. This reduction in interest expenses is similar to the reduction in interest expenses that would be made possible through the refinancing of CBO's as provided in section 5.

As shown in exhibit C, the funds interest expenses would be considered in setting loan interest rates under the formula provided in section 6(1). Therefore, this action together with section 5 would ultimately affect loan interest rates. This is illustrated in exhibit D, which shows that under the no growth scenario, loan interest rates would average 7.8 percent without sections 4 and 5 and 7.4 percent with these sections. In this scenario, loan interest rates would be reduced, thereby, resulting in larger loan subsidies.

Considering the impact of sections 4 and 5 on loan interest rates and in turn loan subsidies, the Congress may wish to consider the effects of these provisions in addressing the subsidy issue.

This injection of resources also would allow the fund to operate farther into the future before appropriations would be needed. For example, as shown in exhibit D, appropriations would be needed by 2005 under the no growth scenario and without sections 4 and 5. In contrast, the need for appropriations would be put off until 2016, a difference of 11 years, if sections 4 and 5 were put into law.

Furthermore, this capitalization of Treasury debt is analagous to appropriating \$1 billion to the fund today. As shown in exhibit B, the present value of this Treasury debt is about \$1 billion. However, because this action would take place outside the budget/appropriation process, we believe it represents a form of "backdoor" financing. In the past, we have objected to similar "backdoor" financing schemes because they lessen the Congress's ability to control the federal budget.

If the Congress desires to capitalize this debt, we recommend that appropriations be used to accomplish this. Appropriations have been used in the past to capitalize other funds, including the Rural Telephone Bank administered by REA. Further, this action would be consistent with our recommendation⁶ to use appropriations to retire Amtrak's debt to the government.

As an alternative, the Congress should consider making appropriations to cover any and all loan subsidies that might result from its actions in establishing new REA loan interest rates. If this were done, the fund would be able to repay its Treasury debts as they become due. In addition, the fund's net

⁶This recommendation was made in our March 28, 1980, report on "Alternatives for Eliminating Amtrak's Debt to the Government" (PAD-80-45).

equity as shown in exhibit B could eventually be returned to the Treasury to defray the interest cost that the Treasury has had to absorb through the waiver of interest on this debt. More importantly, by appropriating all loan subsidies, we believe the Congress would be provided with a better perspective of the cost of REA's loan program.

The appropriation of loan subsidies also would be consistent with section 6(3) of the bill which would require REA to request an appropriation each year to replenish the fund for subsidies made during the preceding fiscal year on loans made at less than the standard interest rate as provided in section 6(1) of the bill. In this respect, section 6(3) could be amended to cover all loan subsidies. In addition, this provision could be further amended to provide for making appropriations on a prospective rather than retroactive basis, that is the amount appropriated should be adequated to cover the full subsidy cost on all loans or advances to be made during the fiscal year in question. If this were done, REA could actually use its appropriations to buy down the interest rate on CBO sales to match whatever interest rate the Congress ultimately decides is appropriate for REA loans.

The amount of funds that would have to be appropriated to fund subsidies, that is to buy down the loan interest rate, will depend on the REA loan interest rate, the rate being charged on CBO's, and the amount of loan advances to be financed in any fiscal year. Exhibit F contains an example of a matrix similar to one that might be used to determine the appropriations needed to buy-down loan interest rates.

Besides using appropriations to capitalize Treasury debt or fund all or part of REA loan subsidies, we recommend that the Congress bring the revolving fund back on-budget. When the revolving fund was established in 1973, its activities were placed off-budget. We have consistently opposed off-budget programs,

including this one,⁷ because such programs do not have to compete for resources within the same decision framework applied to on-budget programs, although such programs may be equally worthwhile.

Madam Chairman, this completes my prepared statement and I would be pleased to answer any questions at this time.

⁷The off-budget status of REA loans was discussed in our November 28, 1980, report on "Financing Rural Electric Generating Facilities: A Large and Growing Activity" (CED-81-14).

GOVERNMENT'S COST TO FINANCE
\$850 MILLION IN CAPITAL EXPENDITURES
(Life Cycle Cost in Present Value Terms)

	Government's <u>Cost</u> (in million)
 <u>IOU's</u>	
Federal income taxes lost from:	
Investment tax credits	\$ 85
Accelerated versus straight line depreciation	<u>84</u>
Total	\$169 <u><u> </u></u>
 <u>Public utilities</u>	
Federal income taxes lost from sale of tax-exempt bonds	
	\$279 <u><u> </u></u>
 <u>REC's</u>	
Subsidy from REA direct loans	\$404* <u><u> </u></u>

*Government's cost to finance REC's is 2.4 times the cost to finance IOU's and 1.4 times the cost to finance PU's.

CASH FLOW STATUS OF REVOLVING FUND

	<u>Amount in</u>	
	<u>Current</u>	<u>Present</u>
	<u>dollars</u>	<u>value</u>
	<u>(note a)</u>	<u>(note b)</u>
	<u>---in billions---</u>	
Cash Receipts:		
Loan Repayments	\$25.9	\$8.3
CBO sales for unadvanced loans	<u>.3</u>	<u>.3</u>
Total	<u>26.2</u>	<u>8.6</u>
Cash Payments:		
Loan Advances	2.7	2.1
Interest on CBO's	11.3	3.7
Repurchase of CBO's	3.6	.2
Repayment of Treasury Debt	<u>7.9</u>	<u>1.0</u>
Total	<u>25.5</u>	<u>7.0</u>
Net Receipts or Equity of Fund	.7	1.6
Less: Interest Waived on Treasury Debt	<u>12.6</u>	<u>9.8</u>
Cost of REA Programs to Taxpayer	<u>\$11.9</u>	<u>\$8.2</u>

^aCurrent dollars in the year received or paid.

^bAssuming a 11 percent discount factor, which is equivalent to the Government's current long term borrowing costs as of June 1983.

Standard Rate Formula

<u>Loan</u>	<u>Interest</u>	<u>Sum of</u>	<u>Loan</u>	<u>Appro-</u>	<u>Accounts</u>
<u>advances</u>	<u>expense</u>	<u>advances and</u>	<u>receipts</u>	<u>priations</u>	<u>obligations</u>
<u>+</u>	<u>=</u>	<u>interest expense</u>	<u>-</u>	<u>=</u>	<u>=</u>
\$ 1,100	\$400	\$1,500	\$900	- 0 -	\$600

Computation of Standard Rate

Accounts obligations	\$600
Interest Rate on CBO's	
(11 percent)	<u>.11</u>
Interest expense on accounts	
obligations	\$ 66
Divided by loan advances	<u>\$1,100</u>
Standard Rate	.06 or 6 percent

EXPECTED INTEREST RATES UNDER SECTION 6(1) (note a)

	<u>Without Sections 4 and 5</u>	<u>With Section 4 and 5 (note b)</u>
Assuming no growth in program levels (c):		
Low	5.0%	5.0%
High	12.4%	11.2%
Average (d)	7.8%	7.4%
Year Appropriations First Needed	2005	2016
Assuming 6 percent growth in program levels:		
Low	5.0%	5.0%
High	11.2%	10.6%
Average (c)	9.7%	9.6%
Year Appropriations Needed	2005	2014

a/Based on a CBO interest rate of 11 percent, which was the government's cost of long term borrowing as of June 1983.

b/ Does not consider the full impact of section 5 considering the uncertainty of predicting the extent to which interest rates on new CBO's will decline in the future.

c/Program lending remains at the current level of about \$1.1 billion.

d/As computed by GAO.

FINANCIAL STATUS OF REA
ELECTRIC DISTRIBUTION BORROWERS
AS OF DECEMBER 1981

	<u>2.5 TIER</u>								
	<u>Total</u> <u>Number</u>	<u>Percent of</u>		<u>30% Equity Ratio</u>			<u>40 % Equity Ratio</u>		
		<u>Column</u> <u>Total</u>	<u>Line</u> <u>Total</u>	<u>Total</u> <u>Number</u>	<u>Column</u> <u>Total</u>	<u>Line</u> <u>Total</u>	<u>Total</u> <u>Number</u>	<u>Column</u> <u>Number</u>	<u>Line</u> <u>Total</u>
Distribution Borrowers: Reporting Equity Ratio's:	921	100	100	305	100	33.1	199	100	21.6
With Electric Rates Lower Than:									
Avg. IOU Electric Rate:									
Total lower	447	48.5	100	193	63.3	43.2	126	63.3	28.2
Up to 10% less	158	17.2	100	62	20.3	39.2	41	20.6	25.9
11% to 20% less	168	18.2	100	88	28.9	52.4	64	32.2	38.1
21% or more less	121	13.1	100	43	14.1	35.5	21	10.5	17.4
Avg. IOU Residential Rate:									
Total lower	681	73.9	100	257	84.3	37.7	174	87.4	25.6
Up to 10% less	200	21.7	100	55	18.0	27.5	35	17.6	17.5
21% to 20% less	201	21.8	100	70	23.0	34.8	44	22.1	21.9
21% or more less	280	30.4	100	132	43.3	47.1	95	47.7	33.9
Avg. REC Residential Rate:									
Total lower	414	45.0	100	182	59.7	44.0	126	63.3	30.4
Up to 10% less	162	17.6	100	62	20.3	38.3	39	19.6	24.1
11% to 20% less	134	14.5	100	75	24.6	38.1	56	28.1	41.8
21% or more less	118	12.8	100	45	14.8	39.0	31	15.6	26.3

SUBSIDY FUNDS REQUIRED FOR EACH DOLLAR LOANED*

Government's
Cost of
Borrowing
(CBO Rate)

	<u>REA Loan Interest Rate</u>								
	<u>5%</u>	<u>5.5%</u>	<u>6%</u>	<u>6.5%</u>	<u>7%</u>	<u>7.5%</u>	<u>8%</u>	<u>8.5%</u>	<u>9%</u>
	-----dollars-----								
9%	.369	.327	.276	.234	.193	.142	.098	.046	-
10%	.426	.388	.341	.304	.265	.219	.178	.131	.085
11%	.476	.441	.398	.363	.328	.285	.247	.204	.162
12%	.533	.485	.446	.414	.381	.342	.306	.267	.227

*Based on monthly payments of interest only for the first 3 years with monthly principal and interest payments thereafter for the remaining 32 years on a 35 year loan.

ASSUMPTIONS USED TO PREPARE EXHIBIT A

- All capital is used to purchase assets subject to the investment tax credit (10%).
- The depreciation base is equal to the capital assets purchased less 50 percent of the investment tax credit. No salvage value is assumed.
- Assets are subject to accelerated depreciation over 15 years (straight-line basis) and straight-line depreciation over 35 years, which is the term for REA loans.
- The income taxes lost from accelerated depreciation represents the difference in the tax savings to IOUs between accelerated depreciation and straight-line depreciation assuming a standard corporate income tax rate of 46 percent after discount savings to their present value at 11 percent based on the Government's cost of long-term borrowing in June 1983.
- IOU's raised their capital through the sale of utility bonds, therefore no federal income taxes would be lost through tax benefits aimed at encouraging the reinvestment of stock dividends.
- The taxes lost on tax-exempt public utility bonds represents the taxes investors would have paid had they received semi-annual interest payments at 13 percent on 25-year term bonds and had an effective marginal tax rate of 30 percent, after discounting the annual taxes at 11 percent. The 13 percent rate represents the average yield investors would have received had they purchased

taxable utility bonds issued by IOU's. The 30 percent tax rate is the bracket Treasury uses to calculate the incremental impact of tax-exempt bonds on the Federal deficit. For easy in calculating the taxes lost, we assumed PU's were issuing 25-year term bonds. In actuality, series bonds are used and because they provide for the periodic repayment of principal over the loan term, the actual taxes lost would be less than that shown.

--All REA loans were obtained at the maximum 5 percent interest rate, or 6 percentage points less than the government's 11 percent cost of borrowing in June 1983.

--Federal income taxes lost from the tax-exempt status of PU's and REC's have no impact on the cost of capital as they are related directly to income.

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESSLEGISLATION NEEDED TO
IMPROVE ADMINISTRATION OF
TAX EXEMPTION PROVISIONS
FOR ELECTRIC COOPERATIVESD I G E S T

Because electric cooperatives are exempt from Federal income taxes, GAO wanted to know whether the laws are adequate and whether they are being effectively administered by IRS. GAO found that since electric cooperatives were granted exemption almost 60 years ago, the operations of many cooperatives and the environment in which they do business have changed substantially.

In administering tax exemption, IRS has tried to recognize the changes in electric cooperatives. However, it has had difficulty doing so because of the broad nature of the statute. The law generally exempts all electric cooperatives regardless of differences in their operations and activities, financial condition, size, or mix of consumers served.

IRS needs to make administrative changes to better enforce existing tax exemption provisions. More importantly, the Congress, using alternatives suggested by GAO as a guide, should establish a tax treatment which better recognizes the changing operations and present day environment of many electric cooperatives and their continuing need for assistance.

MANY ELECTRIC COOPERATIVES
HAVE CHANGED SUBSTANTIALLY

Originally, most electric cooperatives were small associations which distributed electricity to sparsely populated rural areas. These cooperatives were made exempt from Federal income taxes under section 501(c)(12) of the Internal Revenue Code, which provides exempt status to mutual or cooperative companies deriving their income principally from members.

(GAO/GGD-83-7)

JANUARY 5, 1983

Today, many electric cooperatives serve both rural and suburban areas and closely resemble investor-owned utility companies in their operations and activities. In 1935, only about 30 electric distribution cooperatives existed, the largest of which had 63 miles of line and just 350 members. As of 1981, 920 electric distribution and power supply cooperatives were in operation with an average of 2,020 miles of line and about 10,400 consumers. Moreover, electric cooperatives' total operating revenues grew from \$230 million in 1950 to about \$7.4 billion in 1981.

Some electric cooperatives have expanded their activities by forming subsidiaries and associations of cooperatives which generate power, provide financing, own and lease coal mining properties and facilities, procure fuel and supplies, and provide ancillary business services. Others have expanded through the acquisition of small investor-owned utilities and interests in jointly-owned power generation plants. (See pp. 9 to 21.)

Another indication of electric cooperative growth is that many cooperatives have been able to accumulate and retain substantial amounts of member equity or patronage capital--about \$3.9 billion as of December 31, 1981. A basic cooperative operating principle is that cooperatives should provide service at cost and distribute any margins or savings to members in proportion to their business or patronage. Under this principle the actual refunding of members' patronage capital is a management decision based on an assessment of cooperative operating needs and planned growth. Some cooperatives are using equity management plans to assist in balancing their financial requirements with their need to return members' patronage capital. Others have no such plans or intentions to establish them. (See pp. 34 to 38.)

IRS HAS PROBLEMS ADMINISTERING TAX EXEMPTION PROVISIONS

In administering tax exemption, IRS has tried to consider the changes in electric cooperatives' operations and the environment in which

they do business. It has taken positions on tax exemption issues and has published requirements electric cooperatives must meet to qualify for exempt status. However, IRS has been hampered by the broad legislation which has not changed significantly since the 1920s and, thus, does not reflect differences in many present day cooperatives. (See pp. 42 to 44.)

IRS' compliance program centers on the one specific legislative criteria--the requirement that 85 percent or more of a cooperative's income be collected from members for the sole purpose of meeting losses and expenses. But even this requirement has proven difficult for IRS to administer and for electric cooperatives to comply with. IRS has not provided sufficient guidance for cooperatives to properly compute the member income test. Furthermore, in view of the significant amounts of tax-free nonmember income permitted under law--more than \$160 million in 1981--it is questionable whether the 85 percent member income requirement is still the best way to assist small cooperatives. (See pp. 45 to 48.)

To facilitate IRS' administration of tax exemption, GAO recommends that IRS take certain actions, including providing more complete guidance on the computation of the member income test. (See p. 49.)

GAO RECOMMENDS ADOPTION OF A TAX
TREATMENT WHICH BETTER RECOGNIZES
CHANGES IN SOME ELECTRIC COOPERATIVES

Unlike Federal assistance programs which can be directed to those organizations having a continuing need for assistance, tax exemption applies across-the-board to all electric cooperatives. Thus, despite changes in the operations and activities of some electric cooperatives, all cooperatives continue to benefit from tax exemption provided they meet the broad statutory requirements of section 501(c)(12) of the Internal Revenue Code.

GAO recommends that the Congress establish a tax treatment to better recognize the changes

in electric cooperatives' operations and activities. To this end, GAO proposes alternatives to the present law which would (1) modify electric cooperatives' nonmember income allowance, or (2) eliminate that allowance, and/or (3) apply tax rules already applicable to other types of cooperatives. GAO emphasizes that these alternatives, which would have an estimated revenue impact ranging from \$2 million to \$45 million, are by no means all inclusive. Rather, GAO suggests them as a framework for the Congress' consideration. (See pp. 54 to 56.)

AGENCY COMMENTS AND
GAO'S EVALUATION

The National Rural Electric Cooperative Association, IRS, and the Departments of Agriculture and the Treasury comments ranged from general agreement on administrative issues by IRS to total disagreement by NRECA. The Edison Electric Institute was also asked to comment but declined the opportunity. (See Apps. V to VIII.)

NRECA disagreed with GAO's conclusions regarding the changes in the circumstances which initially motivated Federal Government involvement in rural electrification and on the extent to which present day cooperative operations and activities have changed. In contrast, IRS stated that electric cooperatives are much different today. GAO reemphasizes that while the special circumstances and operating environment of some cooperatives may not have changed, those of others have changed substantially. Yet, tax exemption continues to apply across-the-board to all electric cooperatives and does not recognize differences in their operations. (See pp. 31 to 33.)

Agriculture and NRECA contended that the report does not recognize the need for electric cooperatives to retain member equity and that taxing cooperatives could affect their ability to build up equity levels. GAO recognizes that cooperatives need to retain equity capital to become self-sufficient but emphasizes that in accordance with cooperative operating principles, cooperatives are to return to members amounts

accumulated above reasonable business needs. GAO also believes that cooperatives could find equity management plans useful for assuring that a proper balance is achieved between building needed equity and returning patronage capital and suggests that REA encourage the use of such plans. (See pp. 40 and 41.)

GAO also points out that under its proposed alternatives, electric cooperatives generally would be taxed only on their nonmember income and that such taxes should have little impact on electric cooperatives' ability to build equity. Moreover, these tax treatments would better recognize the differences in present day electric cooperatives and would be a step towards more equitable taxation of the Nation's electric consumers. (See pp. 59 and 60.)

NRECA also disagreed with GAO's findings and conclusions concerning the problems and difficulties related to IRS' administration of the tax exemption provisions. In contrast, IRS essentially agreed with GAO in this regard. (See pp. 51 to 53.)

Treasury commented that GAO's proposed alternatives should have included the outright repeal of tax exemption. In this regard, Treasury questioned the need for any type of Federal subsidization of cooperatives and stated that GAO's report should have been expanded to cover all types of assistance to electric cooperatives. GAO points out that while the issues raised by Treasury merit consideration, they were not within the scope of GAO's review. (See pp. 8 and 59.)

SUMMARY FROM THE DEPARTMENT OF AGRICULTURE'S
OFFICE OF INSPECTOR GENERAL'S MAY 20, 1983, REPORT ON
"LOAN MAKING POLICIES FOR ELECTRIC DISTRIBUTION COOPERATIVES"

I - SUMMARY OF AUDIT RESULTS

Our analysis of the Rural Electrification Administration's operation of the revolving fund and loan-making policies and procedures, and our review of 32 electric distribution cooperatives disclosed significant problems within the electric loan program. The revolving fund is rapidly deteriorating and will eventually require Congressional appropriations unless interest rates can be increased and loan criteria changed. We found that cooperatives receive REA assistance regardless of financial need or whether they still serve rural areas. Operating procedures also need to be strengthened to ensure that loan funds are disbursed and used only for purposes approved in the 2-year work plan.

The following summaries describe these problems:

- Because REA is required by law to limit interest rates to 5 percent on loans made from the revolving fund, and because the cost of Government borrowing over the past 10 years has significantly exceeded those rates, REA has begun selling the fund's assets to finance the program. By 1985, REA's interest expense will exceed interest income. Unless interest rates charged to borrowers are increased to reflect the cost of Government borrowing, and/or loan criteria and ratios are changed, REA will have to seek Congressional appropriations to subsidize the fund. These monies would be in addition to the \$307 million a year in subsidies presently obtained through interest-free notes to the U.S. Treasury. The subsidies have totaled about \$2.8 billion through September 30, 1982. Both our current audit and a prior General Accounting Office (GAO) report have shown that many cooperatives could obtain outside financing at higher interest rates without a significant adverse effect to rural electric users.

REA and the Office of General Counsel have interpreted the Rural Electrification Act and Congressional Directives to allow loans to be made to cooperatives regardless of their financial strength or the urban/rural characteristics of their service areas. Consequently, REA continues to provide loans to borrowers whose service areas are no longer rural, as defined in the Act, and to borrowers that are financially sound and could obtain credit from other sources. Many of these cooperatives' retail electric rates are lower than comparable investor-owned utilities. We selected 50 cooperatives which according to TIER and equity ratios appeared to be financially sound to determine if their financial positions were similar to those of neighboring investor-owned or municipal systems. We found that 44 of the cooperatives were in a stronger financial position than neighboring investor-owned or municipal utilities providing similar services.

- We also determined the effect higher interest rates would have on these cooperatives. For 37 of the 50 cooperatives which had received an REA loan in the past 5 years, we noted that increasing cost of interest (to reflect the cost of borrowing to the Government) did not alter the retail electric rates substantially. REA itself has determined that over 45 percent of REA cooperatives currently have retail electric rates lower than those of comparable investor-owned utilities. GAO reports have also shown cooperatives could qualify for financing at commercial terms and still provide electric service with no significant increases in residential electric rates.
- Our judgment sample of 38 cooperatives located within 50 miles of a large urban center disclosed 34 whose service areas were no longer entirely rural. A detailed review of 9 of the 34 cooperatives revealed that they were predominantly serving the suburban residents of major metropolitan areas. For example, 76 percent of the 34,000 consumers of one cooperative lived in the suburban communities surrounding Washington, D.C. The median household income of these consumers was over \$25,000 or 22 percent higher than the national average. The nine cooperatives received recent REA loans totaling over \$147 million.
- Although REA requires borrowers to submit a work plan that specifies the intended use of the loan funds, we noted during our reviews of 32 cooperatives that borrowers did not always limit the use of the loan funds to these authorized purposes. Twenty-six of the cooperatives used funds for purposes not included in the work plan, and 20 reapplied for new loan funds, using portions of the previously approved and funded but unbuilt items in the work plans as the basis for the new loan requests. At least \$61.9 million of the \$421 million in REA and supplemental loans made to the 32 cooperatives were advanced on work orders which contained unapproved construction items and for work completed in prior work plans. For example, at one cooperative over \$28 million was approved for three work plans. We found that the cooperative used \$6.6 million for purposes not included in the plans and did so without REA approval. We also noted that shortly after obtaining the loan advances, the cooperative invested \$4.2 million of the monies at rates ranging from 13.25 to 16 percent.
- REA attempts to control loan disbursements to cooperatives by requiring that their general fund levels fall below 8 percent of Total Utility Plant before loan advances can be made.

However, we found that cooperatives often circumvented this control. In one instance, REA officials provided information which assisted a cooperative in obtaining an unnecessary loan advance. These conditions allowed 22 of the 32 cooperatives reviewed to drawdown \$44 million in loan funds prematurely or without immediate need for the funds. Of this amount, over \$33 million (borrowed from REA at 2 or 5 percent) was invested in high-yield certificates for periods of 90 days or more and at terms up to 20.75 percent. For example, one cooperative reduced its general fund level below 8 percent 18 times to obtain loan advances totaling \$18 million. To accomplish this, the cooperative prepaid power costs, prepurchased supplemental financing certificates, prepaid long-term debt to REA and retired patronage capital. The cooperative invested \$1.1 million of the loan draws in high-yield certificates for periods in excess of 90 days.

II - RECOMMENDATIONSADMINISTRATOR, RURAL ELECTRIFICATION ADMINISTRATION

1. Seek legislative authority to change loan-making criteria and ratios, in combination with an increase in the insured loan interest rates up to the Government cost of borrowing, to improve the financial condition of the Revolving Fund. REA should reduce and subsequently eliminate Federal funding to cooperatives capable of obtaining financing from non-Federal sources and assign interest rates based upon borrowers' ability to pay. (See Details - 1 and 2.)
2. Establish criteria to evaluate cooperative needs for REA financing based upon an individual cooperative's financial strength and retail electric rates. Require cooperatives to establish retail electric rates, whenever possible, which ultimately enable them to obtain total outside financing. (See Details - 2.)
3. Request legislative authority to redefine eligible rural areas. This should take into account the significant changes in population patterns which have occurred since the inception of the Rural Electrification Act. (See Details - 2.)
4. Identify those cooperatives which no longer serve an eligible area and/or are financially strong, and evaluate their need for continued REA assistance. For those cooperatives which are in an urban area, and which cannot secure outside financing, develop a system of diminishing assistance (with reasonable timeframes) according to the cooperatives' financial condition. (See Details - 2.)
5. Require that borrowers use loan funds only for items contained in an approved construction work plan, and instruct borrowers to obtain REA approval of changes in work plans before loan funds are advanced for these purposes. Discontinue the practice of reimbursing cooperatives for work completed prior to the period of the work plan. (See Details - 3.)
6. Use REA field personnel to conduct reviews to assure that funds are used only for loan purposes identified in the approved work plan and that cooperatives' requests for loan advances comply with applicable procedures. Review each cooperative's use of general funds to identify nonconstruction transactions having a material effect on the cooperative's general fund level at the time of the loan request. (See Details - 3 and 4.)

7. Disburse loan funds to cooperatives according to their use of general funds for current approved construction expenditures, and according to their need for the funds at the time of the loan request. In determining need, establish policy regarding recent expenditures for nonconstruction purposes and their effect on the general fund level at the time of the loan request. (See Details - 4.)
8. Establish policy to deobligate all unadvanced loan funds after the expiration of a reasonable timeframe. Take action to deobligate all outstanding advances that fall outside the established constraints and ensure timely monitoring of unliquidated obligations in the future. (See Details - 4.)