

September 2000

FINANCIAL
MANAGEMENT

Impact of RUS'
Electricity Loan
Restructurings



G A O

Accountability * Integrity * Reliability

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Abbreviations

CFC	National Rural Utilities Cooperative Finance Corporation
FFB	Federal Financing Bank
G&T	generation and transmission
OMB	Office of Management and Budget
RD	Rural Development
RE Act	Rural Electrification Act of 1936
RUS	Rural Utilities Service
SFFAS	Statement of Federal Financial Accounting Standards
USDA	Department of Agriculture



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Accounting and Information
Management Division

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September 29, 2000

The Honorable John R. Kasich
Chairman
Committee on the Budget
House of Representatives

The Honorable Stephen Horn
Chairman, Subcommittee on Government
Management, Information and Technology
Committee on Government Reform
House of Representatives

This report responds to your request, as expressed in your letters of October 15, 1999, and March 23, 2000, to review the Rural Utilities Service's (RUS) policies, procedures, and assumptions used when restructuring loans of financially troubled borrowers to mitigate future loan losses. Increased competition in the electricity industry has increased the risk of the federal government incurring future losses on loans to generation and transmission (G&T) cooperatives. This risk is directly related to the G&Ts' ability to set their rates in a competitive and/or regulated market at a level sufficient to recover all their costs. In fiscal year 1999, under its debt settlement authority, RUS restructured the loans of two financially troubled G&T borrowers which totaled \$737 million after the restructuring. In the event that G&Ts are unable to establish a competitive position within the electricity industry, it is probable that in the future, RUS will have to use its debt settlement authority to restructure additional G&T borrowers' loans that represent \$19 billion of the \$28 billion electric loan portfolio as of September 30, 1999. Based on agreement with your staff, we reported to you separately in a February 10, 2000, letter¹ on RUS' loan origination policies and procedures for making new G&T loans. In that letter, we recommended that the Secretary of Agriculture direct the Acting Administrator of RUS to develop and document written procedures to ensure consistent implementation of its G&T loan origination policies. In this report, we have focused on RUS' restructurings of loans made to two financially troubled G&T borrowers prior to implementation of the Federal

¹Rural Utilities Service: Loan Origination Policies and Procedures for Generation and Transmission Loans (GAO/AIMD-00-89R, February 10, 2000).

Credit Reform Act of 1990. Specifically, you asked us to determine (1) RUS' policies and procedures for restructuring financially troubled G&T loans and whether these are being consistently followed, (2) whether RUS properly carried out loan restructurings in accordance with criteria defined in the Federal Credit Reform Act of 1990 and Office of Management and Budget (OMB) guidance, (3) how much it cost the federal government to restructure RUS' debt since enactment of its debt settlement authority, and (4) whether the costs of restructured loans are accurately reported.

Results in Brief

While RUS generally followed its policies and procedures for restructuring loans of two financially troubled borrowers, we found one instance where RUS' policies were not fully utilized and other instances where procedures could be improved. For example, RUS' policies provide that a borrower may be required to obtain credit support from its member distribution cooperatives, such as obtaining a co-signature when restructuring the G&T loans. RUS exercised this option for only one of the two financially troubled borrowers, and in that case, only a portion of the restructured note was guaranteed by the G&T's member distribution cooperatives. A co-signature allows RUS to seek payment from the member distribution cooperatives if the G&T defaults on its restructured loans, which could help mitigate future loan losses to the government by better securing the restructured loans. In addition, RUS' procedures lack detailed written criteria for determining when a borrower should be added or removed from RUS' list of financially troubled borrowers. RUS maintains this list to assist in minimizing the federal government's risk of loss by identifying those borrowers that require additional monitoring of their ability to repay the loans. Lack of detailed written criteria increases the potential for not properly identifying those loans that require increased monitoring and for inconsistent determinations as to when to add or remove a borrower from the list.

RUS properly carried out its loan restructurings under its debt settlement authority in accordance with the Federal Credit Reform Act of 1990 and OMB guidance.² Under Credit Reform, loan restructurings are classified as either "workouts" or "modifications" and, depending on the classification, require significantly different accounting and/or budgetary treatment to accurately measure and report the costs associated with restructured

²OMB Circulars A-11 and A-34 include guidance for implementing credit reform and provide the criteria used to identify workouts versus modifications.

loans. Among other differences, modifications require new budget authority while workouts do not. OMB concluded, and we agree, that the costs of workouts are considered to be part of the costs of defaults and are not treated as modifications. In this case, RUS restructured the loans of two financially troubled borrowers under its debt settlement authority to maximize its recovery in the face of imminent default. Thus, any changes in the original terms of the loan or guarantee as a result of restructuring should be classified as a workout rather than a modification. Therefore, RUS did not have to obtain new budget authority to cover the cost of the restructurings.

RUS' restructuring of the borrowers' loans resulted in new borrowing agreements that included significant concessions, such as noninterest bearing notes, notes that included payments based on contingencies such as the sale of assets, and forgiveness of interest. These two borrowers had outstanding RUS debt of \$331 million and \$406 million, respectively, after their debt was restructured. RUS estimated that it could lose approximately \$185 million on loans restructured for the first borrower and between \$110 and \$120 million on loans restructured for the second borrower, on a net present-value basis. These estimates may change based on several events that could occur in the future. For example, according to RUS and an independent consultant, the exact cost of restructuring one borrower's debt may vary from current estimates because the debt restructuring agreement contains contingencies, such as the borrower paying the principal outstanding based on net proceeds from asset sales, which may result in RUS receiving more or less from the borrower than current estimates.

As part of the debt restructuring agreements, RUS entered into transactions with the borrowers and a third-party creditor that resulted in RUS acquiring the borrowers' non-RUS guaranteed debt, totaling about \$12.3 million. According to RUS officials, the acquisition of the borrowers' debt held by a third party and not guaranteed by RUS was in RUS' best interest. RUS reached this conclusion because, among other things, it allows RUS to make all the creditor decisions in the final development of the restructured agreement, improves RUS' security interest in the restructured loans, and increases RUS' flexibility to make decisions concerning the sale or other marketing of the borrowers' nuclear assets.

Rural Development (RD)³ did not include in its fiscal year 1999 financial reports the estimated loss of \$185 million RUS anticipates will occur as a result of restructuring loans for one borrower, and included only \$30 million of RUS' estimated \$110 to \$120 million anticipated loss on the restructured loan for the other borrower. Also, RD did not record in its accounting records a \$7.2 million forgiveness of interest due to the agency as a result of restructuring one of the borrower's loans. These errors occurred because RD lacked documented procedures to ensure that debt forgiveness, as well as estimated losses resulting from restructuring loans, were properly reported in the financial statements.

The overall outcome of RUS' restructuring activities will not be known for some time and will be significantly affected by the unfolding of events surrounding the current move towards competitive electricity markets. It is uncertain how these events will affect the remainder of RUS' \$19 billion G&T electric loan portfolio; however, it is likely that additional restructurings and losses will occur. To the extent that additional restructurings occur, it is essential that RUS fully utilize all measures available to minimize the risk of loss from these problem loans and ensure that losses that do occur are properly recorded and reported to Congress and other decisionmakers. We are making several recommendations to address these accounting and reporting deficiencies.

RUS and RD generally agreed with the thrust of our recommendations directed toward improving the accuracy of estimated future loan losses and the procedures to be employed when loans are restructured. However, RUS disagreed with our position that it had not fully used the member guarantee option when it restructured certain G&T loans and did not agree that such guarantees were mandatory. Our point is that if RUS decides to obtain member guarantees as part of a restructuring agreement, the guarantees should cover all loans and remain in effect until all loans are repaid in order to optimally protect the government's interest. With regard to our conclusion on RD's inaccurate reporting of costs associated with restructured loans, RD disagrees with our assessment because the allowance for loan loss is an accounting estimate and RD believes that the issue is one of "timely" reporting rather than accurate reporting. While we agree that estimates can never be totally "accurate," in this case, even though the loss estimates had been determined at the time of the

³RUS is a component of RD's mission area. RD provides accounting services to RUS for its electric, telecommunications, and water and environmental loan programs.

restructuring, they were not fully reflected in RD's fiscal year 1999 financial statements, which were issued 9 months after the last restructuring.

Background

RUS, an entity within the Department of Agriculture (USDA), provides direct loans or loan guarantees primarily to rural electric cooperatives that market power on a wholesale and retail basis. Most RUS borrowers are either G&Ts or distribution cooperatives. A G&T cooperative is a nonprofit rural electric system whose chief function is to sell electric power on a wholesale basis to its owners—distribution cooperatives and other G&T cooperatives. A distribution cooperative sells the electricity it buys from a G&T cooperative to its owners, the retail customers.

In the 1970s and 1980s, RUS provided financing for several G&Ts that had invested in the construction of large nuclear and coal-fired generating power plants. Several of these plants were completed late and over budget. In addition, an expected increase in demand for electric power did not materialize, and as a result, several of these G&Ts became financially troubled and could not meet their debt-servicing requirements. In turn, the federal government incurred several billion dollars in loan losses. For example, from fiscal year 1992 through July 1999, RUS wrote off \$1.8 billion of debt related to financially troubled G&Ts and is in the process of writing off an additional \$3 billion of the \$4.1 billion in loans owed by a borrower as directed by the bankruptcy courts. We reported⁴ that it is probable that the federal government will continue to incur losses from loan write-offs related to RUS borrowers that were bankrupt or financially troubled. In addition, we reported that it is also probable that future losses will arise from other RUS borrowers with high production costs and the inability to raise rates because of regulatory and/or market pressures.

⁴*Rural Utilities Service: Status of Electric Loan Portfolio* (GAO/AIMD-99-264R, August 17, 1999).

Under Public Law 104-127, the Secretary of Agriculture has the authority to compromise, adjust, reduce, or charge off debts or claims arising from loans made or guaranteed, such as those obtained by G&Ts, under the Rural Electrification Act of 1936 (RE Act).⁵ The Secretary of Agriculture has delegated this authority to the Administrator of RUS, with respect to loans made or guaranteed by RUS.⁶

The Federal Credit Reform Act of 1990 governs how RUS should budget for loans and loan guarantees made under the RE Act. The act requires that the budget reflect a more accurate measurement of the government's subsidy costs⁷ for federal direct loans and loan guarantees, which permits better cost comparisons both among credit programs and between credit and noncredit programs. In addition, accounting standards for credit programs were developed to ensure that financial reporting for credit program activities generally mirror the requirements of the Federal Credit Reform Act of 1990. The requirements for budgeting and accounting for the costs of debt restructurings are drawn from the Federal Credit Reform Act, OMB guidance, and RUS' authority to make loans and loan guarantee commitments and its debt settlement authority. The costs of the workouts/restructuring of debt in imminent or actual default are not considered modifications, but are considered to be part of the cost of default for which the agency has permanent, indefinite budget authority.

Scope and Methodology

We selected for review all troubled debt restructured by RUS under its authority granted in Public Law 104-127 dated April 4, 1996. Two debt restructuring agreements had been completed by the agency under this authority as of May 1999. In addition to these two restructurings, another borrower had requested that RUS settle its debt in the form of debt

⁵According to 7 CFR 1717, a claim is defined as any claim of the government arising from loans made or guaranteed under the RE Act, as amended, to a rural electric borrower. Debt is defined as, but not limited to, outstanding principal, accrued interest, penalties, and the government's costs of debt collection arising from loans made or guaranteed under the RE Act.

⁶Prior to April 4, 1996, the Department of Justice had to approve all write-offs that were part of any agreement RUS reached with a G&T to restructure its debt.

⁷The credit subsidy cost is the government's estimated net cost, in present value terms, of direct or guaranteed loans over the entire period the loans are outstanding. The data used for these budgetary estimates are generally reestimated after the fiscal year-end to reflect any changes in actual loan performance since the budget was prepared.

forgiveness. However, restructuring of the borrower's loans did not materialize because RUS negotiated a deal that resulted in the borrower merging with another RUS borrower considered financially viable. As part of this deal, the financially viable borrower assumed the debt of the financially troubled borrower.

To determine RUS' policies and procedures for restructuring financially troubled G&T loans, we reviewed RUS' policies outlined in regulation 7 CFR 1717.1200, *Settlement of Debt* and RUS' operating procedures documented in Staff Instruction 1717Y-1, *Processing Requests for Settlement of Debt Owed by Electric Borrowers*. In addition, we interviewed RUS officials to obtain background information regarding the enactment of RUS' authority.

To determine if RUS consistently followed its policies and procedures when restructuring the loans of two financially troubled borrowers, we reviewed RUS' administrative documents supporting the debt restructuring agreements and compared those documents to RUS' policies and procedures. We also reviewed both financially troubled borrowers' applications to RUS requesting settlement of debt to determine whether the documents included with each borrower's application supported its statement that it was unable or would be unable to meet its financial obligations in the short term. We interviewed RUS officials regarding the status of RUS' list of financially troubled G&T borrowers and the criteria it uses to add and remove borrowers from the list. In addition, we interviewed officials at the National Rural Utilities Cooperative Finance Corporation (CFC) to identify policies and procedures it uses when restructuring financially troubled borrowers' debt. We did not verify the accuracy of the underlying data RUS used to assess the borrowers' need for debt settlement, nor did we reperform any of RUS' procedures to approve the borrowers' application for debt settlement.

To determine whether RUS properly carried out loan restructurings in accordance with criteria defined in the Federal Credit Reform Act of 1990 and OMB guidance, we interviewed RUS' Office of General Counsel staff and OMB officials. In addition, we reviewed the Federal Credit Reform Act of 1990, as amended by the Balanced Budget Act of 1997, RUS' authority under the RE Act and its debt settlement authority, and our Office of General Counsel analyzed how troubled debt restructurings should be budgeted and accounted for based on the requirements of those laws.

To determine how much it cost the federal government to restructure RUS' debt since enactment of its debt settlement authority, we analyzed debt restructuring agreements and supporting documentation, independent consultants' reports, agency and borrower financial reports, and held discussions with agency program, accounting, and budget officials. We did not determine the administrative costs, such as salaries, associated with the debt restructurings because that information was not tracked by the agency and could not be readily determined.

To determine whether the costs of restructured loans have been accurately reported, we reviewed agency audited financial statements and supporting records. We compared cost data included in the debt restructuring agreements to the agency's financial statements and supporting records. We interviewed agency accounting staff to determine policies and procedures used to estimate losses on outstanding loan balances. In addition, we interviewed budget staff to determine how loan losses are reported in the budget. Because RUS is a component of USDA's Rural Development mission area, RUS' financial data are included in Rural Development's consolidated financial statements.

We conducted our review from September 1999 through July 2000 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Administrator of the Rural Utilities Service or his designee. The Administrator provided us with written comments, which are discussed in the "Agency Comments and Our Evaluation" section and reprinted in appendix II.

Policies and Procedures for Loan Restructurings Were Not Fully Utilized and Could Be Improved

RUS' policies for the settlement of debt and claims owed by rural electric borrowers are documented in 7 CFR 1717.1200, *Settlement of Debt*. This regulation implements RUS' statutory authority to settle borrowers' debts and claims arising from loans made or guaranteed to rural electric borrowers under the Rural Electrification Act of 1936.⁸ RUS' internal Staff Instruction 1717Y-1, *Processing Requests for Settlement of Debt Owed by Electric Borrowers*, documents the procedures for processing borrowers' requests for settlement of debt owed to RUS. Key policies and procedures are discussed in more detail in appendix I.

⁸The Rural Electrification Act of 1936, as amended (7 U.S.C. § 901 et seq.), provides the basic statutory authority for the electricity and telecommunications programs, including the authority for loans to be made by the Federal Financing Bank.

While RUS generally followed its policies and procedures for restructuring loans of two financially troubled borrowers, we found one instance where RUS' policies were not fully utilized and other instances where procedures could be improved. For example, RUS' policies provide that a borrower may be required to obtain credit support from its member distribution cooperatives, such as obtaining a co-signature when restructuring the G&Ts' loans. RUS exercised this option for only one of the two financially troubled borrowers, and in that case, only a portion of the restructured note was guaranteed by the G&T's member distribution cooperatives. A co-signature allows RUS to seek payment from the member distribution cooperatives if the G&T defaults on its restructured loans. Requiring a co-signature could help mitigate future loan losses to the government by better securing the restructured loans. In addition, RUS' procedures lack detailed written criteria for determining when a borrower should be added or removed from RUS' list of financially troubled borrowers. Federal internal control standards require that (1) internal control procedures be clearly documented, (2) the documentation be readily available for examination, and (3) the documentation appear in management directives, administrative policies, or operating manuals.⁹ RUS maintains the list to assist in minimizing the federal government's risk of loss by identifying those borrowers that require additional monitoring of their ability to repay the loans. Lack of detailed written criteria increases the potential for not properly identifying those loans that require increased monitoring and for inconsistent determinations as to when to add or remove a borrower from the list.

In the first two restructurings completed under its debt settlement authority, which we will refer to as borrower A and borrower B, RUS only obtained a member guarantee for borrower B, and in that case, only a portion of the restructured note was guaranteed by that G&T's members. For this borrower, RUS made three restructured notes totaling \$331 million. Of the \$331 million, RUS required the borrower's members to guarantee approximately 3 percent (about \$10.2 million). In addition, RUS has agreed to reduce the guarantee by 7 cents for each dollar of original principal paid on the first two notes and eliminate the member guarantee after the notes are paid. RUS stated that the level of guarantee obtained

⁹*Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, November 1999). These standards provide an overall framework for establishing and maintaining internal control and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.

was based on the value of the members' equity. However, we believe that this does not maximize the government's security in the restructured loans because the level of guarantee is reduced as the first two loans are repaid and then eliminated for the life of the third loan. Had RUS structured the guarantee to include the third loan until it was paid in full, it would have maximized its recovery chances. That is, the guarantee would have remained in effect for the third loan which has significant risk because payment of this note is contingent on net proceeds from asset sales and other recovery mechanisms. RUS' debt settlement policies outlined in 7 CFR 1717.1200 include various factors to consider when restructuring a borrower's loan, including obtaining member guarantees to secure loans. This practice of requiring member guarantees is used by CFC, a private, not-for-profit cooperative association whose principal purpose is to provide its members with a source of financing to supplement the loan programs of RUS. CFC officials stated that when it restructures troubled debt of G&T borrowers, its policy is to obtain guarantees from the borrower's member systems. Utilizing member guarantees, to the greatest extent possible, when restructuring loan agreements could help reduce the government's risk of future losses even if the amount guaranteed is not a substantial part of the loan.

In addition, RUS' procedures lack detailed criteria used to determine when a borrower should be added or removed from RUS' list of financially troubled borrowers. For example, RUS' procedures require that any borrower assigned to RUS' Financial Services Staff—who monitor financially troubled borrowers—will automatically be designated as financially troubled. No other criteria is documented as to when to add a borrower to the list. Also, RUS' procedures require that a borrower be removed from the list when its financial troubles have been successfully mitigated. However, there is no explanation provided to define "successfully mitigated." RUS' broad criteria documented in its procedures does not reflect the detailed definitions used by RUS and communicated to us during this and a previous assignment. In September 1997, we reported¹⁰ RUS management's definition of a financially troubled borrower. According to RUS, borrowers considered financially troubled have either defaulted on their loans, had their loans restructured but are still experiencing financial

¹⁰*Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses* (GAO/AIMD-97-110 and 110A, September 19, 1997). This report discusses the federal government's net costs and exposure to future financial losses to support electricity-related activities, including RUS.

difficulty, declared bankruptcy, or have formally requested financial assistance from RUS. During this assignment, in an interview with a senior RUS official, we were told that borrowers are removed from the list of financially troubled borrowers when RUS is no longer actively negotiating with that borrower regarding its outstanding debt. Although RUS staff are aware of the various criteria used, not documenting this criteria increases the potential for not properly identifying those loans that require increased monitoring. Other improvements we believe RUS could make to its procedures for reporting the cost of restructuring G&T debt are discussed later in this report.

RUS Properly Carried Out Loan Restructurings

RUS properly carried out its loan restructurings under its debt settlement authority in accordance with the Federal Credit Reform Act of 1990 and OMB guidance. Under Credit Reform, loan restructurings are classified as either “workouts” or “modifications” and depending on the classification, require significantly different accounting and/or budgetary treatment in order to accurately measure the costs associated with restructured loans. As mentioned earlier, RUS restructured loans totaling about \$737 million for the two financially troubled G&T borrowers under its debt settlement authority. Both debt restructuring agreements were completed during fiscal year 1999. RUS restructured these loans to provide the borrowers more favorable payment terms and to improve the borrowers’ competitive position and ability to repay their loans. New borrowing agreements were made as part of both debt restructurings, which included significant concessions such as issuing noninterest bearing notes and allowing the borrowers to make payments based on contingencies, including net proceeds from asset sales.

The accounting and/or budgetary treatment for a workout significantly differs from the treatment of a modification. A workout does not require an agency to obtain budget authority in the current year to cover the full cost of the loan or guarantee over its remaining life. The cost of the revision under a workout (e.g., a change in cash receipts and/or any defaults that may occur in the future) is recognized in the budget over the remaining life of the restructured loan or guarantee in the year(s) the change in the cost occurs. However, for a modification, Credit Reform requires an agency to obtain budget authority in the current year to cover the full cost of the modified loan (referred to as subsidy) over its remaining life. Also, the full cost of the modified loan or guarantee must be reflected in the agency’s current year financial statements and budget. While agencies are required to annually reestimate the subsidy cost, Congress provided permanent,

indefinite authority to cover the difference between the reestimated cost and prior estimate. Therefore, improper classification of restructured loans could result in RUS and Congress not having accurate budgetary and financial statement data to help make informed decisions about future funding needs for the electric loan program.

RUS classified the loans it restructured under its debt settlement authority as workouts and not modifications in accordance with the Federal Credit Reform Act and OMB guidance. When the government takes an action that differs from the actions assumed in the original estimates and changes the estimated cost of an outstanding loan or guarantee from the current estimate of cash flows, such as eliminating any fees associated with the program, the action must be classified as a loan modification, which requires new budget authority. On the other hand, if the action is allowed by an existing statute, under the original terms of the loan or guarantee, or was included in the original estimate of the subsidy cost, such as a restructuring as a result of imminent or actual default, then the revision to the loan or guarantee should be classified as a workout, although the estimated cost of the loan or guarantee may be altered. Therefore, OMB concluded, and we agree, that the costs of workouts are considered to be part of the costs of default and are not treated as modifications. Here, RUS restructured the loans of two financially troubled borrowers under its debt settlement authority to maximize its recovery in the face of imminent default. Thus, any changes in the original terms of the loan or guarantee should result in classifying the restructuring as a workout rather than a modification. As a result, RUS did not have to obtain new budget authority to cover the cost of the restructurings.

The Federal Government Has Incurred Costs on Restructured Loans

The federal government has incurred costs related to restructuring loans for the two financially troubled borrowers. These two borrowers had outstanding RUS debt totaling about \$737 million after their debt was restructured. RUS stated that it could lose approximately \$185 million on loans restructured for borrower B and between \$110 and \$120 million on loans restructured for borrower A. These estimates may change based on several events that could occur in the future. For example, according to RUS and an independent consultant, the exact cost of restructuring borrower B's debt may vary from current estimates because the debt restructuring agreement contains contingencies, such as the borrower paying the principal outstanding based on net proceeds from asset sales, which may result in RUS receiving more or less from the borrower than current estimates. RUS restructured the borrowers' loans to provide more

favorable payment terms to improve the borrowers' competitive position and ability to repay the loans. RUS officials reported that they negotiated the best deals possible for the federal government taking into consideration, among other things, the probability that the borrowers would file for bankruptcy, which according to RUS, would leave minimal or possibly no funds available for RUS to collect on the troubled debt.

As part of the debt restructuring agreements, RUS entered into transactions with the borrowers and a third-party creditor that resulted in RUS acquiring the borrowers' non-RUS guaranteed debt. According to RUS officials, the acquisition of the borrowers' debt held by a third party and not guaranteed by RUS was in RUS' best interest. RUS reached this conclusion because, among other things, acquiring the borrowers' debt allowed RUS to make all the creditor decisions in the final development of the restructured agreement, improves RUS' security interest in the restructured loans, and increases RUS' flexibility to make decisions concerning the sale or other marketing of the borrowers' nuclear assets. Also, the third party agreed that RUS could acquire the borrower's debt at a significant discount. RUS' acquisition of the borrowers' non-RUS guaranteed debt to maximize its recovery of the restructured loans in the face of imminent default is allowed under RUS' broad authority to settle debt related to loans and loan guarantees under the RE Act. Thus, RUS' acquisitions of the non-RUS guaranteed debt are not considered new loans under Credit Reform and, therefore, do not require the agency to obtain budget authority to cover the cost of the new loans.

RUS' restructuring of the borrowers' loans resulted in new borrower agreements that included significant concessions like noninterest bearing notes, notes that included payments based on contingencies such as the sale of assets, and forgiveness of interest. Both borrowers had significant investments in nuclear power facilities, which, according to RUS officials, had questionable market value under a forced liquidation proceeding such as bankruptcy. From a negotiating standpoint, RUS officials stated that they needed to balance RUS' objective of minimizing the federal government's losses against the likely outcome of forced collection of assets at current market prices in the event of bankruptcy. RUS officials also estimated that the government's recovery would most likely have been minimal or possibly zero under a forced collection scenario. The following is a brief discussion of the agreements between RUS and the two borrowers whose loans were restructured under RUS' debt settlement authority.

RUS' Agreement With Borrower A

On May 28, 1998, borrower A submitted an application to the RUS Administrator requesting debt settlement under RUS' debt settlement authority. The borrower's financial difficulties stemmed from high production costs of its nuclear generating asset as well as state initiatives establishing retail competition. Prior to submitting its application, borrower A pursued opportunities to reduce administrative overhead, improve efficiency and effectiveness, and expand its markets and revenues. However, according to RUS, these actions could not alleviate borrower A's financial difficulties. In 1997, RUS undertook a review of borrower A's member systems operations to identify inefficiencies and opportunities for cost savings. RUS reported that while savings could be realized if the member systems changed their operating practices, such as updating their meter reading systems and combining customer service groups, these savings, if realized, would have little effect on the overall competitiveness of members' retail rates.

On March 29, 1999, RUS and borrower A entered into a debt restructuring agreement to address the borrower's financial stress. This restructuring agreement included the borrower's RUS-guaranteed Federal Financing Bank (FFB)¹¹ debt, but not the borrower's direct loans held by RUS at that time. Prior to the restructuring, borrower A's FFB debt totaled about \$416 million. After the restructuring, borrower A's new note totaled \$406 million. According to RUS, the \$10 million difference in principal resulted from RUS reducing the amount due by the borrower's payments received during the restructuring process. The new note, with an interest rate of 7.18 percent, replaces old notes with interest rates ranging from 5.18 percent to 10.3 percent. Also included in the \$406 million note is a \$95 million balloon payment due at maturity on January 1, 2008. However, RUS recognizes that the borrower should have several options for payment of the \$95 million, including a reamortization of the amount due. In addition, terms of the \$406 million note and borrowing agreement include forgiveness of interest, calculated on a quarterly basis, if all members of the borrower's system agreed to the terms of the debt settlement that are applicable to them, such as paying revised wholesale rates. The amount of interest forgiveness is prorated when there is less than 100 percent participation.

¹¹The Federal Financing Bank is a government corporation under the U.S. Treasury created by Congress to centralize and reduce the cost of federal and federally assisted borrowing from the public.

In addition, RUS and borrower A entered into another loan agreement that resulted in RUS paying \$1.07 million to CFC to satisfy debt that borrower A had with CFC, but was not guaranteed by RUS. RUS acquired borrower A's \$3 million net outstanding debt with CFC at a substantial discount by agreeing to offset the \$1.07 million from amounts CFC owed RUS under a separate debt settlement arrangement.

RUS' Agreement With Borrower B

On March 2, 1999, borrower B submitted an application to the RUS Administrator requesting debt settlement under RUS' debt settlement authority. The borrower's financial difficulties stemmed from high production costs of its nuclear generating asset and significant rate disparity between the borrower's wholesale power costs and those of its competition. Prior to submitting its application, borrower B undertook efforts to address its financial stress. These initial efforts, among others, included cost-cutting measures, renegotiation of its power supply contracts with another utility, refinancing of RUS-guaranteed debt, and sale of its transmission facilities to another RUS borrower. However, these efforts did not resolve borrower B's financial stress.

On May 6, 1999, RUS and borrower B entered into a debt restructuring agreement to address the borrower's financial stress, with an effective date of April 30, 1999. Prior to the restructured agreement, borrower B's debt held by RUS totaled about \$310 million. After the restructuring, borrower B's debt totaled about \$331 million. The increase in principal amount held by RUS after the restructuring is a result of RUS acquiring borrower B's other debt that was held by a third party and not guaranteed by RUS. The \$331 million consists of three new notes that all mature on December 31, 2008. Two notes are interest-bearing, with an interest rate of 5.23 percent. The remaining note is noninterest bearing. However, the exact amount of recovery cannot be assured since payments are not fixed, but are based on the amount of available cash for debt service and the net proceeds from the sale of borrower B's nuclear and other assets. As a result, forgiveness of principal may occur if the net proceeds are insufficient to pay off the notes.

As part of the debt restructuring agreement, RUS acquired borrower B's loans with CFC. RUS negotiated with CFC to acquire the \$31 million of CFC loans at a significant discount for \$9.3 million. To carry out the acquisition, RUS, CFC, and borrower B entered into a formal purchase agreement where the borrower was directed to skip a payment to FFB and use the funds to make a \$9.3 million payment to CFC on behalf of RUS. RUS made payment to FFB for the missed scheduled payment and in turn,

incorporated the acquired debt in borrower B's newly restructured notes resulting from the debt settlement agreement. Borrower B no longer has any debt service obligations to CFC.

Rural Development Did Not Accurately Report RUS' Costs for Restructuring G&T Debt

RD did not include the estimated loss of \$185 million RUS anticipates will occur as a result of restructuring loans for borrower B in the agency's fiscal year 1999 financial reports. In addition, only \$30 million of RUS' estimated \$110 million to \$120 million anticipated loss on the restructured loan for borrower A was included in RD's fiscal year 1999 financial reports. Also, RD did not record in its accounting records a \$7.2 million forgiveness of interest due to the agency as a result of restructuring borrower A's loans. These errors occurred because RD lacks documented procedures to ensure that debt forgiveness, as well as estimated losses resulting from restructuring loans, is properly recorded in the financial reports. Until this situation is corrected, Congress and other decisionmakers cannot rely on the reported costs of RUS' electric loan program included in RD's annual consolidated financial statement reports.

Lack of Documented Policies and Procedures Has Led to Improper Reporting of Estimated Losses for RUS' Electric Loan Portfolio

RD did not properly report estimated future loan losses for the restructured loans. Reporting errors occurred for the restructured loans because RUS' procedures for processing borrower's requests for settlement of debt owed to RUS do not include accounting staff responsibilities during the loan restructuring process to ensure proper reporting of the cost of restructuring the debt as well as amounts due after the restructuring. Also, RD lacks documented procedures to ensure that losses estimated to occur as a result of restructuring loans are properly calculated and net loan balances are reported in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*.¹² For example, when recording borrower B's restructured loans, no loss was included in the agency's estimated future loan losses calculation for electric loans, even though RUS stated that it anticipated recovery of less than half of the loans on a net present value basis. For borrower A, RD significantly understated RUS' estimated loss. Specifically, in its financial reports, RD reported that a \$30 million

¹²SFFAS No. 2, which generally mirrors the Federal Credit Reform Act of 1990, requires that all direct loans obligated and loan guarantees committed after September 30, 1991, be accounted for on a present value basis.

estimated loan loss would occur on the restructured loan. However, this information is inconsistent with one of RUS' program documents which states that "the debt settlement negotiated would result in a write-off of between \$110 and \$120 million with respect to outstanding RUS-guaranteed FFB debt in the principal amount of \$416.1 million."

Also, RD did not document whether it considered applicable accounting requirements outlined in SFFAS No. 2 when it calculated estimated loan losses for the electric loan portfolio.¹³ SFFAS No. 2 provides guidance for reporting estimated future loan losses on direct loans and loan guarantees. One of the key factors used to estimate future loan losses is default costs. The default cost of direct loans results from any anticipated deviation, other than prepayments, by the borrowers from the payments schedule in the loan contracts. The deviations include delinquencies and omissions in interest and principal payments. In estimating default costs, SFFAS No. 2, par. 34, recommends that the following risk factors be considered: (1) loan performance experience; (2) current and forecasted international, national, or regional economic conditions that may effect the performance of the loans; (3) financial and other relevant characteristics of borrowers; (4) the value of collateral to loan balance; (5) changes in recoverable value; and (6) newly developed events that would affect the loan's performance. In addition, SFFAS No. 2, par. 35, requires that if individual accounts with significant amounts carry a high weight in risk exposure, an analysis of the individual accounts is warranted in making a default cost estimate for that category.

During our review of RD's fiscal year 1999 calculation of estimated future loan losses for the electric loan portfolio, we noted that RD does not maintain supporting documentation that addresses the risk factors used to estimate the default costs. Unless RD develops policies and procedures to estimate future loan losses in accordance with SFFAS No. 2 and establishes accounting staff responsibilities during the loan restructuring process, there is no assurance that the accounting information related to the electric loan program provides an accurate basis for Congress and other decisionmakers to evaluate credit program performance.

¹³RUS' credit program receivable data are reported in RD's financial reports. As of September 30, 1999, RD reported \$23.1 billion in pre-1992 electric loans or about 82 percent of the total \$28.1 billion gross electric loans receivable. RD elected to report its pre-1992 electric loans on a net present value basis. SFFAS No. 2 permits, but does not require, restatement of pre-1992 direct loans and loan guarantees on a present value basis.

Other Loan Restructuring Costs Were Not Reported

For borrower A's restructured loans, RD did not record in its accounting records a \$7.2 million forgiveness of interest to the borrower. As part of the debt settlement agreement, RUS provided the borrower debt forgiveness on accrued interest owed. However, this information was not reported in the agency's financial reports. During interviews with RD officials regarding the borrower's debt settlement agreement, we noted that the officials were unaware of all the facts surrounding the borrower's debt settlement agreement and did not have copies of applicable loan file documents maintained by the program office, which outline the terms of the borrower's debt settlement agreement. After further discussions with RD staff, the Deputy Chief Financial Officer agreed that a write-off for the debt forgiveness should have been recorded at the time of the restructuring and the records would be adjusted to reflect the debt forgiveness. Without accurately reporting debt forgiveness associated with the loan restructuring, Congress and other decisionmakers do not have valid cost data to make informed decisions about the electric loan program.

Conclusions

RUS has exercised its broad authority in restructuring the loans of two G&T borrowers, including acquisition of third-party non-RUS guaranteed debt, and providing significant concessions to the borrowers, such as noninterest bearing notes, contingent payments, and forgiveness of interest. RUS officials stated that their main objective is to minimize the federal government's losses and that the restructurings were necessary to carry out this objective. Yet, RUS did not obtain member guarantees on the bulk of the restructured loans and does not have adequate procedures for updating its list of financially troubled borrowers that need special monitoring—two important factors in minimizing potential losses.

Thus far, these restructurings have resulted in estimated losses of \$295 million to \$305 million,¹⁴ of which only \$30 million was reported in RD's financial statements. The overall outcome of RUS' restructuring activities will not be known for some time, and will be significantly affected by the unfolding of events surrounding the current move towards

¹⁴The range of anticipated losses is calculated by combining the dollar amounts of losses for both borrowers. The \$295 million is calculated by adding borrower A's anticipated minimal loss of \$110 million to borrower B's anticipated loss of \$185 million. The \$305 million amount is calculated by adding borrower A's maximum anticipated loss of \$120 million to borrower B's anticipated loss of \$185 million.

competitive electricity markets. It is uncertain how these events will affect the remainder of RUS' \$19 billion G&T electric loan portfolio; however, it is likely that additional restructurings and losses will occur. To the extent that additional restructurings occur, it is essential that RUS fully utilize all measures available to minimize the risk of loss from these problem loans and ensure that losses that do occur are properly recorded and reported to Congress and other decisionmakers.

Recommendations

To better secure the restructured loans and to improve RUS' process to restructure and report financially troubled borrower's loans, we recommend that the Secretary of Agriculture direct the Administrator of the Rural Utilities Service and in some instances, the Under Secretary of Rural Development to take the following actions:

- Utilize member guarantees to the greatest extent possible by ensuring that such guarantees obtained remain in effect until all restructured loans are paid in full.
- Broaden procedures in its Staff Instruction document, 1717Y-1, *Processing Requests for Settlement of Debt Owed By Electric Borrowers* to include
 - the program staff's coordination with accounting staff to provide all relevant information regarding the terms of the borrowers' restructured loans and
 - procedures that identify the criteria RUS uses to determine when a borrower should be added or removed from the list of financially troubled borrowers.
- Develop and document written procedures to estimate future loan losses for its credit program receivables in accordance with Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*.
- Adjust accounting reports to properly disclose the full costs associated with the restructured loans.

Agency Comments and Our Evaluation

We provided RUS and Rural Development with a draft of this report for review and comment. In summary, RUS and RD officials generally agreed with our recommendations to broaden RUS' procedures regarding the coordination of program and accounting staff responsibilities, develop and document written procedures to estimate future loan losses for its credit program receivables in accordance with federal accounting standards, and

adjust its financial reports to reflect the costs associated with the restructured loans. RUS also plans to review the criteria used to determine when to add or remove a borrower from the list of financially troubled borrowers. However, RUS and RD officials disagreed with our conclusions regarding RUS' use of member guarantees when restructuring loans of financially troubled borrowers and its inaccurate reporting of costs associated with the restructured loans.

Specifically, RUS stated that our finding regarding its utilization of member guarantees implies that RUS' efforts were somehow deficient because it did not obtain more guarantees. Further, RUS stated that our conclusion suggests that we disagree with its policy on member guarantees, and that our report "misreads" the requirements of RUS' regulations regarding debt compromise. Our report does not state that RUS should require member guarantees as a condition of debt settlement nor does it imply that RUS should have used the member guarantee option in the case of borrower A. However, our report does state that when RUS exercises its option to require its borrowers to obtain member guarantees, it should utilize these guarantees to the greatest extent possible by structuring the guarantee to include all of the borrower's restructured loans until the last loan is paid in full. This was not the scenario in the case of borrower B. Also, contrary to RUS' statement, we take no issue with RUS' debt settlement policy, which states that the Administrator of RUS will "consider requiring the borrower to obtain credit support from its member systems...." Our discussion of member guarantees in this report is not a suggestion that RUS consider changing its policy, but rather to more fully utilize it to help maximize the federal government's recovery on troubled loans.

With regard to our conclusion on RD's inaccurate reporting of costs associated with restructured loans, RD disagrees with our assessment because the allowance for loan loss is an accounting estimate and RD believes that the issue is one of "timely" reporting rather than accurate reporting. While we agree that estimates can never be totally "accurate," in this case the estimates were significantly understated. As noted by RUS, the restructurings were completed in March and May 1999 and the estimated losses were determined at that time. Yet, because of a lack of communication between the program staff and accounting staff, these loss estimates were not reported in RD's fiscal year 1999 financial statements, which were issued in February 2000. Additionally, for borrower B, RD included an estimated loss of \$200 million in its fiscal year 1998 financial reports. However, accounting staff failed to include any loss estimate for borrower B in the fiscal year 1999 financial reports, even though the

borrower's financial condition continued to deteriorate and the borrower had requested financial assistance from RUS. Thus, the financial statements were inaccurate and misleading in that they did not reflect all known information about loss estimates. A complete presentation of RUS' comments and our responses is provided in appendix II.

As we arranged with your office, unless you publicly announce its contents earlier, we plan no further distributions of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the Honorable John M. Spratt, Jr., and the Honorable Jim Turner, the Ranking Minority Members of your Committee and Subcommittee; the Honorable Daniel Glickman, the Secretary of Agriculture; the Honorable Christopher A. McLean, Administrator of the Rural Utilities Service; the Honorable Jacob J. Lew, the Director of the Office of Management and Budget; and other interested parties. We will make copies available to others upon request.

If you have any questions regarding this report, please contact me at (202) 512-9508 or McCoy Williams, Assistant Director, at (202) 512-6906. Key contributors to this assignment are listed in appendix III.



Linda M. Calbom
Director, Resources, Community,
and Economic Development, Accounting
and Financial Management Issues

Key Policies and Procedures Used to Settle Debt Owed by Electric Borrowers

RUS' policies for the settlement of debt and claims owed by rural electric borrowers are documented in 7 CFR 1717.1200, *Settlement of Debt*. This regulation implements RUS' statutory authority to settle borrowers' debts and claims arising from loans made or guaranteed to rural electric borrowers under the Rural Electrification Act of 1936. This regulation outlines (1) the criteria and factors RUS must use to determine the need for debt settlement, (2) conditions RUS may place on the settlement agreement, (3) debt settlement measures RUS considers when restructuring loans, and (4) consideration of loan requests after debt settlement. The regulation also describes the type of information the borrower must submit to RUS to support the borrower's statement that it is unable or will be unable to meet its financial obligations in the short term. For example, the borrower must provide an analysis of the causes resulting in the borrower's inability to meet its financial obligations. The borrower must also provide a thorough review of opportunities available or potentially available to reduce overhead and other costs and improve the efficiency and effectiveness of its operations.

RUS' internal Staff Instruction 1717Y-1, *Processing Requests for Settlement of Debt Owed by Electric Borrowers*, documents the procedures for processing borrowers' requests for settlement of debt owed to RUS. These operating procedures include the responsibilities of RUS staff assigned to a troubled borrower and their coordination with other offices during the restructuring process. For example, the RUS staff assigned to a troubled borrower must work with various RUS offices within the electric program as well as RUS' Office of General Counsel on issues affecting the borrower's financial condition. RUS' procedures also identify internal documents that staff must prepare, which address the borrower's financial stress and justification for the debt restructure. Two primary documents that staff must prepare as part of the restructuring process include an administrative action document and a recommendation and report document. The administrative action document outlines those measures approved by the Administrator to address the borrower's financial stress. A recommendation and report outlines internal and external factors leading to the borrower's stress; the process used to analyze the borrower's stress; steps taken by RUS, the borrower, and the borrower's member systems to mitigate the borrower's stress; and recommended action to be taken by RUS regarding debt settlement. In addition, the procedures provide that RUS monitor and maintain a list of financially troubled borrowers. RUS' key policies documented in 7 CFR 1717.1200 to settle debt and claims owed by rural electric borrowers are listed below.

Criteria and Factors Used to Determine the Need for Debt Settlement

The Administrator will not settle any debt or claim unless RUS has determined that (1) the borrower is unable to meet its financial obligations under its loan agreement or (2) the borrower will not be able to meet its obligations within 24 months following the month the borrower submits its application for debt settlement to RUS, and in either case, default is likely to continue indefinitely. The determination of a borrower's ability to meet its financial obligations will be based on analyses and RUS' documentation of the borrower's historical, current, and projected costs, revenues, cash flows, assets, opportunities to reduce costs and/or increase revenues, and other factors that may be relevant to the request. In addition, RUS may require that an independent consultant analyze the efficiency and effectiveness of the borrower's organization and operations and those of the borrower's member systems. Also, RUS may require the borrower to employ a temporary or permanent manager during the time the debt settlement is being considered, and possibly for some time after the debt settlement or on a permanent basis, to manage the borrower's operations and ensure that all actions are taken to avoid or minimize the need for debt settlement.

Conditions RUS Considers When Restructuring Loans

During the restructuring process, the Administrator may place conditions on the borrower as part of the debt settlement agreement and/or consider other factors when restructuring a borrower's loans. During the restructuring process, the Administrator will

- not grant relief on debt owed to the federal government unless similar relief, on a pro rata basis, is granted with respect to other secured obligations of the borrower, or the other secured creditors provide other benefits or value to the debt restructuring;
- consider requesting that the borrower or independent consultant solicit competitive bids for the assets of the borrower;
- consider the value of the borrower's assets, including wholesale power contracts¹ between the G&T and its member systems;
- consider rates charged for electric service by the borrower and its member systems;
- consider whether a settlement is favorable to the federal government in comparison to recovery by enforced collection procedures;

¹Wholesale power contracts are long-term contracts that obligate the distribution cooperatives to purchase all of their respective power needs from the G&T.

- require the borrower to provide satisfactory evidence that it has obtained all approvals required by regulatory bodies that are needed to implement rates or other provisions of the settlement;
- require the borrower and its member systems to implement changes in structure, management, operations, and performance deemed necessary;
- consider requiring the borrower to convey some or all of its assets to the federal government;
- consider requiring the borrower to obtain credit support from its member systems, as well as action plans by the members to change their operations, management, and organizational structure to reduce operating costs, improve efficiency, and/or expand markets and revenues;
- require the borrower to warrant and agree that no bonuses or similar extraordinary compensation has been or will be provided, for reasons related to the settlement of debt, to any officer or employee of the borrower or to other persons or entities identified by RUS; and
- require borrower management to certify that all information provided to the federal government in connection with the debt settlement, is true, correct, and complete in all material respects.

Debt Settlement Measures

If the Administrator determines that debt settlement is appropriate, the debt settlement measures considered with respect to direct or guaranteed loans include, but are not limited to, reamortization of debt; extension of debt maturity;² reduction of interest rate charged to the borrower;³ forgiveness of interest accrued, penalties, and costs incurred by the government to collect the debt; and forgiveness of loan principal with concurrence from the Under Secretary for Rural Development. Also, for loans guaranteed under section 306 of the RE Act made by the Federal Financing Bank (FFB) or other third parties, the Administrator may restructure the borrower's obligations by (1) acquiring and restructuring the guaranteed loan, (2) restructuring the loan guarantee obligation, (3) restructuring the borrower's reimbursement obligations, or (4) such

²Extension of maturity shall not extend more than 10 years beyond the latest maturity date prior to settlement.

³The interest rate on any portion of the restructured debt shall not be reduced to less than 5 percent, unless the Administrator determines that reducing the rate below 5 percent would maximize debt recovery by the federal government.

means as the Administrator deems appropriate, subject to such consents and approvals, if any, that may be required by the third party lender.

Consideration of Loan Requests After Debt Settlement

In considering any future loan requests from a borrower whose debt has been settled in whole or part, it will be presumed that the Administrator will require that the borrower provide credit support that is acceptable to the Administrator for the full amount of the loan request. Types of credit support may include, but are not limited to, equity infusions and guarantees of debt repayment, either from the applicant's members or from a third party.

Comments From the Rural Utilities Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

Mr. Jeffrey C. Steinhoff
Assistant Comptroller General
Accounting and Information Management Division
United States General Accounting Office
Washington, D.C. 20548

SEP 14 2000

Dear Mr. Steinhoff:

We appreciate the opportunity to review and comment on the draft General Accounting Office (GAO) report entitled Impact of RUS' Electricity Loan Restructurings (GAO/AIMD-000288). As you know, although your report is addressed to me as the Administrator of the Rural Utilities Service (RUS), much of the report deals with activities of Operations and Management, an element of Rural Development located in St. Louis, a distinction which was missing in an earlier draft of your report. In the interests of economy and timeliness, this consolidated response incorporates the input and observations of Office of the Deputy Chief Financial Officer (DCFO).

See comment 1.

The G&T loan restructurings undertaken by RUS and the Department of Justice over the past fifteen years have all been related to lending decisions initially made more than twenty years ago, most often related to the financing of nuclear power plants¹. As your team observed during our meeting on September 5, 2000, regarding an earlier draft, troubled debt situations are extremely complex and time-consuming. Each restructuring case has unique characteristics, but our approach to every case has a common strategy, that is, to maximize recovery of debt for the benefit of the taxpayer.

See comment 3.

In the main, then, we read your draft report as an endorsement of the manner in which we have used the statutory authority to deal with troubled debt situations. While we do disagree with some of your conclusions and found the tone² of the report to be of concern, we nonetheless appreciate that it contains several constructive observations which will help us improve the procedures for documenting and accounting for our actions.

Our specific observations and responses to your recommendations follow.

See comment 2.

¹ See March 6, 2000 response to Congressman Horn, which was provided, with attachments, to your team.

² For example, we believe that a less sensational, more accurate first sentence of the "Results in Brief" would have read: "With the exception of one area where we believe a change in RUS policy may enhance the security of its restructured debt and a few other instances where procedures could be improved, RUS followed its policies and procedures for restructuring loans of two financially troubled borrowers, and was successful in avoiding any debt compromise in a third case."

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Secretary of Agriculture, Washington, DC 20250

Appendix II
Comments From the Rural Utilities Service

See comment 3.

Conclusion that “RUS’ policies were not fully utilized” is apparently based on GAO disagreement with the policy, not actual RUS performance under it.

Of the many elements, remedies, and considerations contained in the regulation covering the compromise of debt, your team identified a single matter with which it chose to take issue: loan guarantees by G&T members. At length and repeatedly, your report notes the virtues of member system guarantees and implies that RUS efforts were somehow deficient because we did not obtain more of them. As a form of evidence, you cite another lender to G&Ts that obtains such guarantees.

See comment 3.

We recognize that member guarantees can provide, in appropriate circumstances, lenders with some value. However, member guarantees are but one approach to credit support, and care must be taken not to overstate their value. While a detailed discussion of the value of guarantees is well beyond the scope of this response, suffice it to say that guarantees, like all-requirements contracts, are no panacea. They provide no assurance of repayment, since their value is a function of a number of complex factors including the collateral or equity existing at the member level, the ability of the lender to realize on the collateral, and the consequences to the lender of attempting to realize on the collateral. In our view, the discussion in your report regarding member guarantee, and, in particular, the true value of member guarantees as credit support is, at best, superficial.

See comment 4.

Leaving aside the whole question of the value of member guarantees, we believe your report simply misreads the requirements of RUS regulations regarding debt compromises. There is no legal basis allowing us to impose guarantees on G&T members *ex post facto*. Similarly, our regulation does not require such guarantees, but rather states that the Administrator will consider requiring the borrower to obtain “credit support” from its members³. Thus, as we commented during our September 5, 2000 meeting, we believe that your discussion of member guarantees is more accurately a suggestion that we consider changing our policy, rather than a finding that we have not met our obligations under existing policy.

See comment 3.

See comment 5.

In a debt restructuring situation, member guarantees do not come without cost, if they can be obtained at all. In the case of borrower A, for example, we are satisfied that the members would not have signed guarantees under any reasonable (for the lender) conditions. We are similarly convinced that the result of insisting on member guarantees for the G&T debt would have been a G&T bankruptcy, where the size of our eventual recovery would have been in serious doubt and the assets of the member systems would have been unreachable in any event⁴. So, instead, the RUS sought an enhancement of the

³ See Appendix I to your draft report.

⁴ Your team’s observation during the September 5 meeting that the lender, RUS, makes the rules is only appropriate to a limited extent when new financing is occurring. In a debt restructuring, when the money is already out the door, the question of who rules is much murkier and can be turned on its head in

members systems' obligation to support the G&T in the context of newly passed retail choice legislation. This credit enhancement took the form of a contractual affirmation, above and beyond the wholesale power contract, by each member system of its obligation to charge rates sufficient to pay its share of the G&T's obligations. While not, strictly speaking, a member guarantee, we were satisfied that these affirmations were a meaningful new credit support for the restructured debt⁵. Most importantly, we are convinced that the result of the settlement produced significantly greater value for the taxpayer than would likely have resulted from an extended bankruptcy proceeding.

See comment 6.

In the case of borrower B, RUS sought to obtain the greatest amount of guarantees possible from the members. However, the goal of years of negotiations was to construct the optimal mix of assurances and promises of payment. To the extent that higher levels of new, explicit member guarantees were obtained, the amount that the G&T and its members were willing to promise to pay decreased. What ensued was a careful balancing of risks and benefits, wherein we, just like any other similarly situated lender, attempted to fashion the best overall package in terms of optimizing the potential for recovery. In that optimization process, the amount of G&T debt which members were willing to guarantee decreased in amount and term as the members considered the bankruptcy alternative and what their obligations would have been in that scenario⁶. Thus, GAO's conclusion that the member guarantee "package" eventually agreed to by the parties "does not maximize the government's security" is, in our opinion, inaccurate and grossly over-simplified.

See comment 7.

With respect to the supposed example of the other lender, which obtains member guarantees, it is inapposite. As we explained on September 5, CFC has obtained member guarantees only as a part of providing new financing to financially stressed borrowers, unlike the cases being discussed here where existing debt is being reduced through restructuring. In fact, in those situations where RUS and CFC have both restructured debt for a given borrower and we both remained as creditors for that borrower, CFC has not attempted to obtain nor been given member guarantees on their restructured debt⁷.

Reporting and accounting procedures.

Overall, we agree with GAO that procedures need to be established to ensure that the terms of debt restructuring agreements are provided in a timely manner to the DCFO.

However, because the allowance for loan loss account is an accounting estimate, we continue to disagree with GAO's assessment that Rural Development did not accurately

bankruptcy. We have shared our experiences with your team, and would be happy to do so again.

⁵ We have previously suggested that the GAO team contact borrower A to independently verify some of our conclusions and observations with respect to what was reasonably obtainable by the parties.

⁶ RUS and its independent consultant both considered this consensual debt restructure preferable to a bankruptcy.

⁷ Subsequent to our September 5 meeting, we verified this belief with CFC.

See comment 3.

report the costs associated with the restructurings. The issue actually is one of “timely” reporting rather than accurate reporting. GAO states in their report, the RUS staff estimated that it could lose up to \$185 million on one borrower and between \$110 and \$120 million on the other borrower. However, as GAO points out in its report, the estimates may change based on several events that could occur in the future. GAO concluded that “the overall outcome of RUS’ restructuring activities will not be known for some time, and will be significantly affected by the unfolding of events surrounding the current move towards competitive electricity markets.” Thus, the “accuracy” of the estimate will remain in doubt until the end of the loan term. For this reason, we continue to believe that the use of the term “accurate” in this report is misleading and inappropriate.

See comment 3.

Losses should be reported in the financial records during the period in which RUS concludes it is more likely than not that the amounts will not be collected. The two restructuring actions discussed in GAO’s report were completed in March and May 1999. However, documents needed by the DCFO staff to assess the total amount of debt that RUS believed was more likely than not to be written off were not received by the DCFO until after the Fiscal Year (FY) 1999 financial statements were finalized. Thus, the amount included in FY 1999 statements was understated. Based on the documents we have received since the end of FY 1999, the FY 2000 financial statements will be adjusted to reflect any future anticipated write-offs associated with the restructured loans.

Responses to GAO Recommendations

Recommendation 1: Utilize member guarantees to the greatest extent possible by ensuring that member guarantees obtained remain in effect until all restructured loans are paid in full.

See comment 3.

RUS Response: RUS will continue to utilize all tools available to maximize taxpayer value. We believe that we are already utilizing the credit support flexibility accorded by the regulation in a rational, measured manner. Since there is no requirement in the regulations that member guarantees must be obtained, much less that they remain in effect until all restructured loans are paid in full, we consider your recommendation to be a suggestion for consideration whenever the current regulation is revised, not as a criticism of our activities under the existing regulation. RUS will consider this recommendation, but with the understanding that the reality and complexity of debt restructurings militate against “one size fits all” policies.

Recommendation 2: Broaden procedures in its Staff Instruction document, 1717Y-1, *Processing Requests for Settlement of Debt Owed by Electric Borrowers* to include

- The program staff’s coordination with accounting staff to provide all relevant information regarding the terms of the borrowers’ restructured loans and
- Procedures that identify the criteria RUS uses to determine when a borrower should be added or removed from the financially stressed list.

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Comments From the Rural Utilities Service

RUS/DCFO Response: The DCFO and the RUS staff will develop procedures for more timely communicating the results of debt restructuring actions to the DCFO, as well as delineating the DCFO's role and responsibilities during the period between the RUS' receipt of the request for restructuring action and the final agreement. The procedures will include timeframes for sending the restructure agreements, executive summary of the restructuring action, copies of working papers, administrative actions, and cash application instructions for over and under payments. In addition, the DCFO has established an annual process for requesting from RUS their assessment of the collectibility of amounts due from troubled borrowers so that the financial reports can timely reflect any amounts that are more likely than not to be unrealized.

See comment 8.

RUS staff will review its staff instruction with respect to identifying specific criteria to be used in determining which borrowers should be considered as financially distressed. It should be noted, however, that the determination of "financial stress" often includes subjective determinations. Our efforts to focus special attention on financially stressed borrowers are in addition to our normal servicing and auditing functions. We are inclined to reject bureaucratic checklists and processes in favor of judgment and common sense.

See comment 9.

We have also noted GAO's discussion regarding the desirability of an official list of stressed borrowers. We will also review our staff instruction to see if this area needs to be bolstered. It should be noted, however, that GAO staff did not identify any situations where a financially stressed borrower has "slipped through the cracks" at RUS.

Recommendation 3: Develop and document written procedures to estimate future loan losses for its credit program receivables in accordance with Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*.

See comment 10.

DCFO Response: Rural Development agrees and has actively participated for 2 years on the USDA Credit Reform Working Group to achieve this goal. The Working Group draws its membership from the USDA Office of the Chief Financial Officer (OCFO), GAO and the USDA Office of Inspector General. The Working Group meets weekly and actively seeks to develop and document written procedures to estimate future loan losses for Rural Development's credit program receivables. The Credit Reform Working Group has on its work plan the task to review and revise, as needed the current process followed to estimate future loan losses for both pre- and post-1991 loans. A specific task addresses developing and documenting written procedures. This task is scheduled to be completed by December 30, 2000.

Recommendation 4: Adjust accounting reports to properly disclose the full costs associated with the restructured loans.

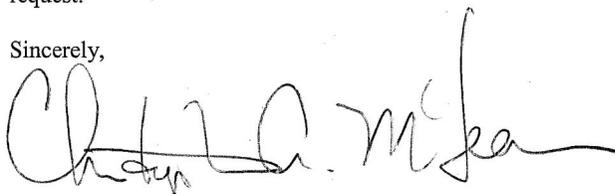
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DCFO Response: Rural Development agrees and the FY 2000 financial reports will be adjusted to reflect the costs associated with the restructured loans.

Again, we appreciate the opportunity to review and comment on the draft report. While the events and national policies that triggered debt restructurings thus far in the RUS electric program seem far removed from today's electric utility industry, they only serve to highlight the need for vigilance and care as we collectively deal with the question of restructuring the electric utility industry across the country. We have a continuing obligation to the country to keep the rural utility infrastructure sound and viable, and are committed to attaining that goal consistent with safeguarding taxpayer dollars.

If you wish to discuss these comments on a more detailed basis, we are available at your request.

Sincerely,



CHRISTOPHER A. McLEAN
Administrator
Rural Utilities Service

The following are GAO's comments on the Rural Utilities Service's (RUS) letter dated September 14, 2000.

GAO Comments

1. We have modified our report to distinguish between Rural Development (RD) and RUS when discussing the errors and weaknesses found in the reporting and accounting procedures for the restructured loans. However, as we have stated in our report, RUS is a component of RD's mission area and RUS' financial data are included in RD's consolidated financial statements.
2. The sentence being referred to is simply a statement of our findings and reads as follows: "While RUS generally followed its policies and procedures for restructuring loans of two financially troubled borrowers, we found one instance where RUS' policies were not fully utilized and other instances where procedures could be improved."
3. Discussed in the "Agency Comments and Our Evaluation" section in the letter report.
4. Regarding member guarantees as credit support, the only aspect we discuss in our report relates to the structuring of the guarantee to include the third loan.
5. Our report does not contain comments or recommendations regarding member guarantees for borrower A.
6. For borrower B, the amount of the initial guarantee represents about \$10.2 million, which is 3 percent of the \$331 million total restructured amount. Under the negotiated agreement, the guarantee only applies to the first two loans and not the third loan. Had RUS structured the guarantee to include the third loan until it was paid in full, it would have maximized its recovery chances. That is, the guarantee would have remained in effect for the third loan which has significant risk because payment of this note is contingent on net proceeds from asset sales and other recovery mechanisms.
7. We agree with RUS' comment that in situations where RUS and CFC both remain creditors for a borrower whose debt is restructured, CFC has not attempted to obtain nor been given member guarantees on its restructured debt. However, we disagree with RUS' comment that the cases where CFC has obtained member guarantees from financially

troubled borrowers differ from the two loan restructurings discussed in this report. In our meeting with CFC officials, they stated that in cases where CFC has bought out RUS' interest and is the sole lender as a result of a troubled debt restructuring, it obtains member guarantees from the borrower's member distribution systems. In addition, CFC officials provided examples of three financially troubled borrowers, where CFC bought out RUS' interest, became the sole lender of those loans, and in all cases obtained guarantees.

8. Our report does not provide a recommendation that RUS prepare and complete checklists when determining whether a borrower is financially troubled.
9. RUS' procedures state that a roster of financially troubled borrowers be maintained. Also, it was beyond the scope of our review to make an assessment of the completeness of RUS' list of financially troubled borrowers.
10. GAO has provided guidance and consultation to the working group, but is not involved in developing USDA policies and procedures.

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