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# RURAL UTILITIES SERVICE

# Opportunities to Operate Electricity and Telecommunications Loan Programs More Effectively

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The Honorable Richard G. Lugar
Chairman
The Honorable Tom Harkin
Ranking Minority Member
Committee on Agriculture, Nutrition,
and Forestry
United States Senate

The U.S. Department of Agriculture's (USDA) Rural Utilities Service (RUS) has used its loan programs to successfully finance the development of electricity and telecommunications infrastructure in rural areas for many years.[1] RUS' loans are intended to assist in the development of sparsely populated rural areas. Recently, the agency wrote off more than $1.7 billion on electricity loans held by a handful of borrowers that did not repay them. More write-offs are anticipated. In April 1997, we reported on the financial condition of RUS' multibillion-dollar portfolio of electricity and telecommunications loans.[2] In summary, that report showed that at the end of fiscal year 1996, about $8 billion of the $37.5 billion in outstanding principal on these loans was held by borrowers experiencing financial problems. We also reported that at the end of calendar year 1995, most electricity and telecommunications loan borrowers had favorable financial characteristics.

In response to the information contained in our April 1997 report, you requested that we conduct a follow-up study focusing on RUS' program operations. Specifically, you asked us to identify ways to (1) make the electricity and telecommunications loan programs more effective and less costly for the government and (2) decrease RUS' vulnerability to loan losses. You also requested that we compile loan information on commercial lenders that have a significant level of lending for rural electricity and telecommunications purposes.

## Results in Brief

This report identifies a number of options that the Congress could consider to make the Rural Utilities Service's electricity and telecommunications loan programs more effective and less costly.

[1]RUS operates the electricity and telecommunications loan programs formerly administered by USDA's Rural Electrification Administration. In this report, we refer to these loan programs as RUS' programs.

[2]Rural Development: Financial Condition of the Rural Utilities Service's Loan Portfolio (GAO/RCED-97-82, Apr. 11, 1997).

Specifically, because the loan programs are intended to assist in the development of the nation's rural areas, targeting loans to borrowers that provide services to areas with low populations could result in the more effective use of the agency's limited loan funds. Current lending practices sometimes result in loans to borrowers serving areas that are heavily populated. Additionally, targeting subsidized direct loans to borrowers that need the agency's assistance to fund their utility projects could result in the more effective use of the loan funds and reduce the level of subsidized loans and program costs. Currently, the agency sometimes makes its subsidized direct loans to borrowers capable of using their own resources or of obtaining loans from the private sector to fund their utility projects. Finally, graduating the agency's financially viable borrowers from direct loans to commercial credit could also reduce program costs. Many of the agency's borrowers are potential candidates for credit from the commercial sector.

Opportunities also exist to decrease the Rural Utilities Service's vulnerability to losses. Specifically, the agency's vulnerability could be lessened if loan and indebtedness limits were established. Some borrowers have been able to obtain large-dollar loans and accumulate large amounts of debt because such limits are generally lacking. Additionally, the repayment guarantee that the agency places on loans made by other lenders could be reduced so that lenders holding the guaranteed loans bear some portion of the financial risk. Currently, the agency guarantees the repayment of loans made by other lenders at 100 percent. However, because all guaranteed loans in recent years have been made by the Treasury's Federal Financing Bank, the risk to the federal government as a whole would not be reduced if the Federal Financing Bank continues to be the sole source of loan funds. Finally, lending policies could be strengthened to ensure that loans are not made to delinquent borrowers or to borrowers that have caused the Rural Utilities Service to incur loan losses. Although the agency did not make or guarantee loans to such borrowers during the period covered by our review, there are no policies prohibiting additional loans to such borrowers.

The Rural Utilities Service is not the only provider of credit to rural utilities. Specifically, two commercial lenders are actively involved in lending to rural electricity and telecommunications providers. These two lenders had approximately $13.1 billion in outstanding principal on loans for rural electricity and telecommunications purposes as of June 30, 1997—an amount equal to 36.4 percent of the outstanding principal on the

Rural Utilities Service's loans. The largest lender—the National Rural Utilities Cooperative Finance Corporation and its affiliated lending organizations—had about $8.9 billion in rural utility loans, and two banking elements of the Farm Credit System had a total of $4.2 billion in rural utility loans.

## Background

RUS, established by the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (P.L. 103-354, Oct. 13, 1994), administers the electricity and telecommunications loan programs that formerly were operated by the Rural Electrification Administration (REA).[3] As part of a general program of unemployment relief, REA was first established by executive order in 1935 to provide loan funds to support the electrification of rural America. At that time, most utilities served high-density areas and did not extend lines to farmers and other rural residents. In 1936, REA was given the statutory authority to operate the electricity loan program, and in 1939, REA became part of USDA. In 1949, REA was authorized to lend funds for telephone services in rural areas.

In recent years, RUS has made or guaranteed an average of about $1.4 billion per year in loans to help borrowers develop, upgrade, or expand their electricity and telecommunications systems. As of June 30, 1997, the outstanding principal on RUS' electricity and telecommunications loans totaled about $36 billion. The Rural Electrification Act of 1936, as amended (7 U.S.C. 901 et seq.), referred to as the RE Act, provides the basic statutory authority for the electricity and telecommunications programs.

## Electricity Loans

RUS makes electricity loans—both direct and guaranteed—primarily to electric cooperatives.[4] It makes direct loans to construct and maintain the distribution facilities that provide electricity to users. It also provides guarantees on loans that are made by other lenders for financing the construction, repair, and improvement of electricity generating and transmission facilities. Nearly all borrowers with electricity loans are nonprofit cooperatives.

[3]RUS also operates USDA's water and waste disposal loan program, which was not included in this review.

[4]Cooperatives are organizations owned by and operated for the benefit of those using their services. Utility cooperatives are owned by the consumers, who elect boards of directors responsible for policy and operations.

RUS' direct loans include both hardship rate loans and municipal rate loans. Hardship rate loans are made to borrowers that meet the following criteria: (1) Their customers have below-average per capita income or below-average median household income for the state, and (2) they have a relatively high cost for providing service, as indicated by a high average revenue per kilowatt-hour sold. Hardship rate loans have a 5-percent interest rate. Generally, municipal rate loans are made to qualified borrowers that do not meet the criteria for hardship rate loans. Municipal rate loans have an interest rate that is tied to an index of municipal bond rates; the rate can change quarterly.

All electricity loans on which RUS has provided repayment guarantees in recent years have been made by the Treasury's Federal Financing Bank (FFB). These loans have an interest rate equal to the Treasury's cost of money plus one-eighth of 1 percent. While RUS can also guarantee electricity loans made by commercial lenders, it has not done so in recent years because borrowers have applied for loans from the FFB, which has lower interest rates than those available from commercial lenders.

## Telecommunications Loans

RUS makes telecommunications loans—both direct and guaranteed—primarily to commercial telephone companies and cooperatives to build and improve telephone and telecommunications facilities and services. These loans are also made for advanced telecommunications facilities and services, such as fiber-optic cabling, digital-switching equipment, and educational television applications. About 72 percent of the borrowers with telecommunications loans are for-profit companies, while the others are mostly nonprofit cooperatives.

RUS' direct loans are hardship rate loans and cost-of-money rate loans. Hardship rate loans are made to borrowers that meet the following criteria: (1) an average of four or fewer customers per mile of telecommunications line in their current service areas, (2) income that is 1 to 3 times more than their interest expenses, and (3) an average of 17 or fewer customers per mile in the area to be served by the project to be funded with the loan. These loans have a 5-percent interest rate. Generally, cost-of-money rate loans are made to borrowers that do not qualify for hardship rate loans and that have an income of 1 to 5 times more than their interest expenses; these loans have an interest rate that matches USDA's cost of money, which currently exceeds the rate for hardship rate loans. RUS also administers the Rural Telephone Bank (RTB) loan program,

in which direct loans are made concurrently with cost-of-money rate loans.[5] RTB loans have an interest rate that matches RTB's cost of money.

RUS also provides guarantees on loans made to commercial telephone companies and cooperatives. As with electricity loans, all guaranteed telecommunications loans in recent years have been made by the FFB, at an interest rate equal to the Treasury's cost of money plus one-eighth of 1 percent. RUS guaranteed only FFB loans because borrowers applied for FFB loans rather than for commercial lenders' loans.

## RUS' Loan Obligations in Recent Years

During fiscal year 1994 through the first three-quarters of fiscal year 1997, RUS made or provided guarantees on 926 electricity and telecommunications loans; these loans totaled about $4.9 billion. Table 1 shows the total number and amount of loans made in each program during this period.

**Table 1: Total Number and Amount of Electricity and Telecommunications Loans Made or Guaranteed by RUS, by Loan Type, Fiscal Years 1994 Through June 30, 1997**

Dollars in millions

| Program/Loan type | Total number of loans | Total dollar amount of loans |
|---|---|---|
| **Electricity** | | |
| Direct hardship rate | 97 | $341.6 |
| Direct municipal rate | 401 | 1,945.4 |
| **Subtotal, direct** | **498** | **$2,286.9[a]** |
| Guaranteed | 36 | 835.5 |
| **Total electricity** | **534[b]** | **$3,122.4** |
| **Telecommunications** | | |
| Direct hardship rate | 49 | 255.4 |
| Direct cost-of-money rate | 157 | 730.9 |
| Direct RTB | 157 | 544.7 |
| **Subtotal, direct** | **363** | **$1,531.0** |
| Guaranteed | 29 | 257.5 |
| **Total telecommunications** | **392[c]** | **$1,788.5** |

[a]Figures do not add to subtotal because of rounding.

[b]A total of 457 borrowers obtained these 534 electricity loans.

[c]A total of 190 borrowers obtained these 392 telecommunications loans. In this program, borrowers frequently receive a combination of loan types—e.g., hardship rate and concurrent cost-of-money rate and RTB loans.

Source: RUS' reports.

[5]RTB is a government-private corporation with federal agency status until it is privatized through the retirement of the stock that the government owns. Privatization began in fiscal year 1996.

## Outstanding Principal Owed on RUS' Electricity and Telecommunications Loans

According to RUS' reports, the outstanding principal owed on electricity and telecommunications loans totaled about $36 billion as of June 30, 1997. Table 2 shows the amount owed in each program.

**Table 2: Amount of Outstanding Principal on Electricity and Telecommunications Loans Made or Guaranteed by RUS, as of June 30, 1997**

Dollars in millions

| Loan type | Electricity loans | Telecommunications loans |
|---|---|---|
| RUS' direct loans | $11,369.1 | $3,385.4 |
| RTB's direct loans | 0 | 1,428.7 |
| Guaranteed FFB loans | 12,989.5 | 333.4 |
| Other guaranteed loans | 649.9 | 1.8 |
| Restructured loans[a] | 5,838.9 | 0 |
| **Total** | **$30,847.4** | **$5,149.3** |

[a]Restructured loans are loans for which the original loan agreements have been altered, including revised repayment schedules and changes in interest rates. These loans include previously issued (1) direct loans made by RUS, (2) guaranteed loans made by the FFB, (3) guaranteed loans made by commercial lenders on which RUS agreed to be directly liable for repaying the loans, and (4) loans that had been owed by borrowers now assumed by other utilities. The amounts cover the principal and the capitalized interest owed on the loans. The loans in this category are not included in the other direct and guaranteed loan categories.

Source: RUS' reports.

## Opportunities Exist to Make the Loan Programs More Effective and Less Costly

RUS' electricity and telecommunications loans are intended to assist in the development of the nation's rural areas. Modifying certain aspects of the electricity and telecommunications loan programs could aid in reaching this goal while reducing the government's cost. First, lending practices could be modified to ensure that the loans benefit areas with low populations, thereby more effectively using the agency's limited loan funds. Currently, borrowers serving areas that are heavily populated sometimes receive loans. Second, RUS' subsidized direct loans could be focused on borrowers that are not capable of using their own resources or of obtaining loans from the private sector to fund their utility projects. Targeting subsidized direct loans to borrowers in need of federal assistance could result in the more effective use of the loan funds.[6] Currently, financially healthy borrowers sometimes receive these subsidized loans. Finally, a graduation program could be instituted to attempt to move RUS' financially viable borrowers with direct loans to commercial sources of credit. This action could allow the agency to

[6]In addition, the cost to the government could be less if the targeted borrowers required a lower dollar volume of subsidized loans than those currently receiving loans.

reduce the interest and administrative-servicing expenses that it now incurs.

## Loans Are Sometimes Made to Borrowers Serving Large Customer Populations

A fundamental concept of both the electricity and the telecommunications loan programs is that funds are to be provided to borrowers for delivering service to sparsely populated rural areas. RUS' regulations require borrowers in both programs to establish that they serve rural areas when they apply for their first loan. Generally, for a new borrower, the population threshold is less than 2,500 for the electricity program and no more than 5,000 for the telecommunications program. However, in both programs, subsequent loans for service can be made without the borrower's having to meet the initial test of serving a rural area. In addition, as the RE Act allows, telecommunications loans can be made for service to nonrural areas when that service is considered incidental to providing service to a rural area.

We found that RUS sometimes makes loans to existing borrowers for providing service to areas where the population exceeds original thresholds for rural areas. For example, an electricity distribution borrower that first received a loan in 1945 received another loan in 1996; in the year prior to receiving this recent loan, the borrower had almost 140,000 customers. This borrower provided service to customers in five counties; one county had about 55,800 residential customers, and another had about 45,100 residential customers. None of these counties was classified as completely rural by USDA's Economic Research Service—all contained an urban population that exceeded 2,500. Furthermore, two of the counties were within a metropolitan area having a population of at least 1 million. Likewise, a telecommunications borrower that first received a loan in 1964 received another loan in 1996; this borrower had about 49,600 residential customers and about 13,700 business subscribers in the year prior to receiving the latest loan. This borrower provided service to customers located in one county, which also was identified by the Economic Research Service as being a county within a metropolitan area having a population that was between 250,000 and 1 million people.

While we did not evaluate the population density of the areas served by all of RUS' electricity and telecommunications borrowers, we did examine customer service statistics as an indicator of population density.[7] We found that 71 electricity distribution borrowers that received loans during

[7]We recognize that some borrowers may serve multiple rural areas, which could result in their having a high number of customers.

calendar years 1994 through June 30, 1997, had more than 25,000 customers; 20 of these borrowers had more than 50,000 customers. Nine of the telecommunications borrowers had more than 25,000 customers; five of these borrowers served a customer base of more than 50,000. (See table 3.)[8]

**Table 3: Number of Electricity Distribution and Telecommunications Borrowers That Obtained Loans During Calendar Years 1994 Through June 30, 1997, by Range of Customers**

| | Electricity program | | Telecommunications program | |
|---|---|---|---|---|
| **Range of customers** | **Number of borrowers** | **Percentage of borrowers** | **Number of borrowers** | **Percentage of borrowers** |
| More than 100,000 | 4 | 0.9 | 0 | 0.0 |
| 50,001-100,000 | 16 | 3.7 | 5 | 3.0 |
| 25,001-50,000 | 51 | 11.8 | 4 | 2.4 |
| 10,001-25,000 | 156 | 36.1 | 12 | 7.1 |
| 5,001-10,000 | 104 | 24.1 | 33 | 19.6 |
| 2,501-5,000 | 75 | 17.4 | 39 | 23.2 |
| 2,500 or fewer | 26 | 6.0 | 75 | 44.6 |
| **Total** | **432** | **100.0** | **168** | **100.0**[a] |

Note: This table covers borrowers that obtained loans from RUS during calendar years 1994 through June 30, 1997, and for which RUS' databases contained information for the year prior to the one in which the loans were made.

[a]Figures do not add to total because of rounding.

Source: GAO's analysis of RUS' automated databases, which contain information submitted by electricity distribution and telecommunications borrowers.

## Loans With Subsidized Interest Rates Are Made to Financially Healthy Borrowers

Unlike the requirements for some other USDA rural credit programs—such as the water and waste disposal, farm, single-family housing, and community facilities loan programs—the RE Act does not require electricity and telecommunications loan applicants to demonstrate that they cannot obtain credit from other lenders before applying for a RUS loan. The act also does not preclude a financially healthy borrower from receiving a RUS loan. As a result, RUS' loans are sometimes made to financially healthy borrowers that may not need federal assistance to fund their utility projects.[9] In addition, some financially healthy borrowers

[8]RUS' automated files contained operational data supplied by 432 electricity distribution and 168 telecommunications borrowers that received loans during calendar years 1994 through June 30, 1997.

[9]In this section of the report, we use various financial measures that provide a broad prospective of the financial strength of RUS' borrowers. A more complete analysis would be needed to assess each individual borrower's financial circumstances.

obtain municipal rate loan funds at interest rates lower than the rate available on hardship rate loans.

## Loans Are Made to Financially Healthy Borrowers That May Not Need RUS' Assistance

The RE Act does not address the effect of an applicant's financial health on the applicant's eligibility to obtain loans in either program. For telecommunications loans, however, the relationship between income and interest expenses influences the type of loan that an applicant may qualify to receive. The RE Act does state that a loan cannot be denied or reduced on the basis of a borrower's level of general funds. However, a provision in 7 U.S.C. 930—a congressional policy declaration on RUS' loan programs that is not part of the RE Act—states that the agency's electricity and telecommunications borrowers should be encouraged and assisted in satisfying their credit needs either internally or through other credit sources.

Many electricity borrowers that obtained loans during calendar years 1994 through June 30, 1997, had favorable financial characteristics.[10] Specifically, almost 56 percent of the borrowers had equity—total assets less total liabilities—of $10 million or more at the end of the year prior to receiving the loans, and another 43 percent had equity of between $1 million and $10 million. In addition, about 40 percent of the borrowers made a profit (net income) of $1 million or more in the year prior to receiving the loans, and another 55 percent made a profit of between $100,000 and $1 million.[11] (App. I provides detailed information on electricity loans to borrowers by various incremental ranges of equity and profit.)

The electricity borrowers also had generally favorable current, debt-to-asset, and times-interest-earned ratios (TIER). The current ratio is a measure showing the extent to which a borrower has sufficient current assets to cover its current liabilities. About 41 percent of the borrowers had a current ratio of 2 or more times, indicating that their level of current assets was at least twice the level of their current liabilities. The debt-to-asset ratio reflects a borrower's debt as a percentage of its assets—it shows the extent to which a borrower has sufficient assets to cover all of its debt. Eighty-six percent of the borrowers had a generally favorable debt-to-asset ratio of 70 percent or less, including 7 percent

[10]RUS' automated files contained financial data supplied by 452 electricity borrowers—432 distribution and 20 power supply borrowers—that received loans during calendar years 1994 through June 30, 1997.

[11]RUS refers to the profits made by electricity and telecommunications borrowers that are nonprofit cooperatives as "net margins."

whose ratio was no more than 40 percent. The TIER shows the extent to which a borrower can pay its annual interest expenses from its net income. Sixty-two percent of the borrowers had a TIER of 2 or more times, which reflects their having at least twice the level of net income as interest expenses. (App. I also provides detailed information on electricity loans to borrowers by various incremental ranges of these three ratios.)

The following are examples of electricity loans to borrowers that had high levels of equity and/or profit. A distribution borrower that received a $4.5 million loan in 1997 had equity of $48.7 million, or almost 11 times the loan amount, at the end of 1996; this borrower also had $5.1 million in profit in 1996. Another distribution borrower had over 3 times more profit than the RUS loan amount. Specifically, this borrower received a $630,000 loan in 1994 and had a profit of $2.1 million in 1993; this borrower also had $12.2 million in equity at the end of 1993. Likewise, a power supply borrower that received a $5.3 million loan in 1995 had $9.1 million in profit in 1994; this borrower had $226.4 million in equity at the end of 1994.

Many telecommunications borrowers that obtained loans during calendar years 1994 through June 30, 1997, also had favorable financial characteristics.[12] Specifically, about 24 percent of the borrowers had equity of $10 million or more at the end of the year prior to receiving the loans, and another 65 percent had equity of between $1 million and $10 million. In addition, about 29 percent of the borrowers made a profit of $1 million or more in the year prior to receiving the loans, and another 61 percent made a profit of between $100,000 and $1 million. Furthermore, about 80 percent of the borrowers had a current ratio of 2 or more times, 83 percent had a debt-to-asset ratio of 70 percent or less, and 87 percent had a TIER of 2 or more times. (App. I provides detailed information on telecommunications loans to borrowers by various incremental ranges of equity and profit, as well as these three ratios.)

The following are examples of telecommunications loans to borrowers that had high levels of equity and/or profit. A borrower that received a $1.1 million loan in 1995 had equity of about $9.2 million, or more than 8 times the loan amount, at the end of 1994; this borrower also had $800,000 in profit in 1994. Another borrower that received a loan of $10.4 million in 1994 had $11.7 million in profit in 1993; this borrower also had $82.9 million in equity at the end of 1993.

[12]RUS' automated files contained financial data supplied by 168 telecommunications borrowers that received loans during calendar years 1994 through June 30, 1997.

RUS incurs a considerable expense in providing direct loans to financially healthy borrowers. The principal cost is associated with the interest rate subsidies—the interest costs associated with loans made at rates below the rate at which RUS borrows from the Treasury.[13] Specifically, RUS' estimated total subsidy costs (not including its administrative costs) on direct electricity and telecommunications loans made during fiscal years 1994 through 1996 totaled $227.5 million: $49.6 million on hardship rate loans and $148.9 million on municipal rate loans in the electricity program (many more municipal rate loans than hardship rate loans were made) and $29 million on hardship rate loans in the telecommunications program. We did not quantify the portion of this estimated cost that relates to interest rate subsidies and the portion that relates to default costs, fees, and other costs. However, hardship rate loans in both programs are made at interest rates that are less than RUS' cost of acquiring funds from the Treasury. The interest rates on municipal rate loans are based on the rates in effect for municipal obligations of similar maturities; the rates on these loans are also less than RUS' cost of borrowing. In addition, RUS has had few repayment problems with its direct loans. Finally, RUS estimated the subsidy costs on the cost-of-money rate loans made during this 3-year period at a far lower amount—$0.1 million. These loans do not have an interest rate subsidy because they are made at rates that match RUS' cost of borrowing.

## Financially Healthy Borrowers Obtain Municipal Rate Loans at Interest Rates Lower Than the Rate on Hardship Loans

Currently, some financially healthy borrowers are obtaining municipal rate loan funds at interest rates that are less than the 5-percent rate available on hardship loans. More specifically, after RUS approves a loan application, a borrower obtains loan funds by taking advances (drawdowns) against the loan. All advances on hardship rate loans bear interest at 5 percent. However, each advance on municipal rate loans bears interest at a rate based on an index of municipal bond rates, which can change each calendar quarter. At the beginning of each quarter, RUS publishes a schedule of the interest rates applicable to advances taken during the quarter. A borrower may take up to eight separate advances of funds on an approved municipal rate loan. For each advance, the borrower selects an interest rate term, which is the period of time used to determine the interest rate. The minimum interest rate term is 1 year, and the maximum is the number of years corresponding to the final maturity date of the loan.

[13]The Federal Credit Reform Act of 1990, which was included as title 13B of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508, Nov. 5, 1990), changed the way post-fiscal year 1991 credit programs are reported. Subsidy cost under credit reform includes net present value estimates of (1) interest costs associated with loans made at rates below the rate at which RUS borrows from the Treasury, (2) default costs, (3) fees, and (4) other costs and revenues.

By selecting shorter interest rate terms, borrowers can obtain interest rates on advances for municipal rate loans that are less than 5 percent. As a result, a borrower with a municipal rate loan can borrow at a lower cost than can a borrower with a hardship rate loan. Specifically, interest rates of less than 5 percent were available on advances for municipal rate loans in 14 of the 15 quarters between January 1, 1994, and September 30, 1997. The lowest rate available in the 15th quarter was 5 percent. As table 4 shows, the interest rates in effect for July 1, 1997, through September 30, 1997, included a range of 3.875 percent for a 1-year interest rate term to 4.875 percent for a 9-year interest rate term.

**Table 4: Range of Interest Rates on Municipal Rate Loan Advances Taken During July 1, 1997, Through September 30, 1997**

| Range of interest rate terms | Range of interest rates |
|---|---|
| 1 year to 9 years | 3.875 to 4.875 percent |
| 10 and 11 years | 5.0 percent |
| 12 years or more | 5.125 to 5.5 percent |

Source: 62 Fed. Reg. 121 (June 24, 1997).

At the end of the interest rate term selected by the borrower for each advance, the borrower has the option of repaying the remaining portion of the advance or rolling it over for a new interest rate term. If the borrower rolls over the remaining amount, depending on the interest rates in effect at that time, the borrower may again obtain an interest rate of less than 5 percent by selecting another short term. However, the borrower runs the risk that interest rates may have increased from the rate initially selected.

Many borrowers that took advances on municipal rate loans obtained interest rates of less than 5 percent. Specifically, 115 borrowers took a total of 210 advances with interest rates of less than 5 percent on municipal rate loans approved during fiscal years 1994 through June 30, 1997. The total amount of these advances was $242 million. For example, a borrower with about 29,500 customers had $25.1 million in equity at the end of 1994. In February 1995, RUS approved a $24.7 million loan, and in August 1995, the borrower took a $12.4 million advance. The borrower selected a 5-year interest rate term and obtained a 4.625-percent interest rate. Another borrower with about 15,400 customers had $19.6 million in equity at the end of 1995. In April 1996, RUS approved an $11 million loan, and in February 1997, the borrower took a $9.4 million advance. This borrower selected a 1-year interest rate term and obtained a 3.875-percent interest rate.

## A Graduation Program Could Assist in Moving Financially Healthy Direct Loan Borrowers to Commercial Credit

While RUS' water and waste disposal loan program has graduation requirements, the RE Act does not require RUS to attempt to move financially healthy direct loan borrowers in the electricity and telecommunications programs to commercial credit sources. RUS officials told us that they have not instituted a graduation procedure because the RE Act is silent on this issue. Because graduation is not an integral part of RUS' operation of these two programs, some borrowers may have direct loans longer than needed and are therefore able to take advantage of the favorable terms that exist with such loans. As a result, RUS continues to incur interest and other administrative expenses in servicing the accounts of its financially healthy borrowers.

Many electricity and telecommunications borrowers with outstanding direct loans as of December 31, 1996, had favorable financial characteristics indicating that they may be viable candidates for having the commercial sector refinance their RUS debt.[14] Specifically, about 39 percent of the borrowers had equity of $10 million or more at the end of calendar year 1996, and another 57 percent had equity of between $1 million and $10 million. In addition, 36 percent of the borrowers made a profit of $1 million or more in 1996, and another 57 percent made a profit of between $100,000 and $1 million.

For example, in the electricity program, one distribution borrower with about $146,000 in outstanding direct loan debt had $27.6 million in equity at the end of 1996 and had made $1.7 million in profit in 1996. This borrower also had a current ratio of 2.3, debt-to-asset ratio of 7 percent, and TIER of 534.6. (These three ratios were previously discussed for the electricity borrowers that received loans during calendar years 1994 through June 30, 1997.) In the telecommunications program, a borrower with about $1.8 million in outstanding direct loans had over $23.4 million in equity, $4.2 million in profit, and a current ratio of 11.7, debt-to-asset ratio of 11 percent, and TIER of 31.2.

Although RUS has no systematic graduation program, borrowers with direct electricity loans may initiate graduation on their own. That is, the RE Act allows a borrower to prepay its outstanding direct electricity loan at a discount—the discounted prepayment amount is the present value of a borrower's outstanding debt. Therefore, borrowers can graduate by seeking and obtaining other financing. The act also provides that a borrower that prepays at a discount cannot obtain another direct loan

[14]RUS' automated files contained financial data supplied by about 1,600 borrowers that had outstanding direct loans as of December 31, 1996.

from RUS for 10 years from the prepayment date. If eligible, however, such borrowers could obtain a guaranteed loan.

RUS' records show that during fiscal years 1994 through June 30, 1997, a total of 107 borrowers prepaid their direct electricity loans at a discount. Their total outstanding debt was more than $1.5 billion, the prepayment amount was about $1.3 billion, and the discount was about $239 million.

Other USDA rural credit programs generally have graduation procedures. For example, RUS' regulations provide for periodic reviews of financial information submitted by direct loan borrowers in its water and waste disposal loan program to determine if the borrowers are likely graduation candidates. When graduation appears possible, a borrower or RUS may submit financial information to other lenders to see if they would refinance the borrower's outstanding direct loan.

## Opportunities Exist to Decrease RUS' Vulnerability to Loan Losses

From a financial standpoint, RUS has successfully operated the telecommunications loan program, but the agency has had, and continues to have, significant financial problems with the electricity loan program. Modifying certain aspects of both loan programs could reduce the agency's vulnerability to losses on new loans. First, loan and indebtedness limits could be imposed. Currently, the loan programs generally lack limits, and, as a result, some borrowers have obtained large-dollar loans and accumulated large levels of debt. Second, the repayment guarantee that RUS places on loans made by other lenders could be reduced so that the lenders participating in RUS' programs would share in the risk of the loans they make. Currently, RUS guarantees 100 percent of other lenders' loans. However, because all guaranteed loans in recent years have been made by the FFB, the risk to the federal government as a whole would not be reduced if the FFB continues to be the sole source of loan funds. Finally, policies could be strengthened to ensure that additional loans are not made to borrowers that are delinquent or that have caused RUS prior losses. While RUS did not make or guarantee loans to such borrowers during the period covered by our review, there are no policies to prevent loans to such borrowers from being made in the future.

### Electricity Program Continues to Be Vulnerable to Loan Losses

During fiscal years 1994 through June 30, 1997, RUS wrote off the debt of five electricity loan borrowers; these write-offs totaled more than $1.7 billion. In February 1994, RUS wrote off about $14 million of debt for a distribution borrower. In addition, RUS wrote off debt for four power

supply borrowers: about $52 million in August 1995, $982 million in September 1996, $502 million in October 1996, and $165 million in June 1997. The majority of these loan losses resulted from investments in nuclear power plants that were either constructed at costs substantially higher than initial projections or abandoned during the construction phase. No borrowers' telecommunications loans were written off during this period.

Additionally, a small number of borrowers still in the electricity program are experiencing serious financial difficulties. These difficulties expose RUS to the risk of more write-offs in the future. As of June 30, 1997, RUS had three borrowers that were delinquent (at least 30 days past due) on scheduled loan payments totaling over $1.2 billion: A distribution borrower was past due on payments of $8.5 million, and two power supply borrowers were past due on payments of $55.2 million and about $1.2 billion, respectively. At the end of June 1997, RUS also had 10 other borrowers—all power supply borrowers—that were experiencing financial distress: They were in bankruptcy, were likely to default on repaying the loans, or had formally requested debt relief. These borrowers owed a total principal of about $7.7 billion on their RUS loans: Six owed between $100 million and $500 million each, two owed between $500 million and $1 billion each, and two owed more than $1 billion each. As we reported in April 1997, these borrowers' problems generally stem from their investments in nuclear-generating plants that were completed late and over budget or in coal-fired generating plants that were built to satisfy anticipated industrial growth that did not occur. On the other hand, no borrowers with outstanding RUS telecommunications loans were delinquent or otherwise financially stressed.

Furthermore, our April 1997 report stated that RUS' electricity loan portfolio faces the possibility of additional financial stress because of increasing competition among the providers of electricity.[15] Competition in the wholesale electricity market is increasing as a result of legislation that was enacted in the early 1990s, such as the Energy Policy Act of 1992 (P.L. 102-486, Oct. 24, 1992). The act encouraged additional wholesale suppliers to enter the electricity market and provided greater access to other utilities' transmission lines. Additionally, the industry in which RUS' telecommunications loan borrowers operate is changing. In particular, there have been rapid advances in technology and changes in the legislative environment, such as the Telecommunications Act of 1996 (P.L.

[15]We also reported similar results in Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses (GAO/AIMD-97-110, Sept. 19, 1997).

104-104, Feb. 8, 1996). These factors could work to either the betterment or the detriment of the borrowers that have telecommunications loans.

## Loan and Debt Limits Could Reduce RUS' Vulnerability to Losses

The RE Act does not limit the amount of an electricity or a telecommunications loan that a borrower may receive or the amount of outstanding indebtedness that a borrower may accumulate through multiple loans. RUS' vulnerability to losses on future loans in the operation of these two credit programs could be reduced if limits were imposed.

RUS has set loan limits only for direct telecommunications loans. Specifically, the maximum amount of a hardship rate telecommunications loan to any one borrower is the lesser of (1) up to 10 percent of the annual loan appropriation or (2) $7 million, an operational level set administratively by the agency in fiscal year 1996. RUS set this maximum amount in order to distribute its limited funds among the largest number of qualified borrowers. Similarly, to ensure that its cost-of-money rate and RTB loan funds are broadly dispersed, on September 5, 1997, RUS published a change to its regulations, providing a limit of 10 percent of the annual loan appropriation to any single borrower. This change became effective on October 6, 1997.

RUS officials in both programs told us that they had not set limits for the other loan types—all electricity loans and guaranteed telecommunications loans—or limits on the amount of debt that a borrower can accumulate because the RE Act does not require limits. Electricity program officials added that they believe they need to be able to provide an applicant with the level of funds needed to support the proposed project.

The general lack of loan limits has allowed RUS to make large-dollar loans to some borrowers. Specifically, while most electricity loans approved during fiscal years 1994 through June 30, 1997, were for less than $10 million, a total of 77 loans, or about 14 percent of the loans, were for $10 million or more. These 77 loans totaled about $1.6 billion, or 51.7 percent of the amount for all loans approved during the period. Similarly, while most telecommunications loans were made for less than $10 million, a total of 36 loans, or about 9.2 percent, were for $10 million or more. These 36 loans totaled about $653 million, or 36.5 percent of the amount for all loans approved during the period. (App. II provides detailed information on loans to borrowers by loan size.)

In addition to the general absence of limits on individual loans, borrowers do not have any limits on the total amount of debt that they can accumulate through multiple loans. As a result, some borrowers owe a high dollar amount of outstanding principal. For example, 128 borrowers with outstanding direct loans in the electricity program as of June 30, 1997, each owed more than $20 million; one owed about $122 million. In the telecommunications program, 38 borrowers with outstanding direct loans each owed more than $20 million; one owed over $100 million.

Loan and debt limits exist in some, but not all, of USDA's rural credit programs. For example, USDA has loan and debt limits on its farm ownership, operating, and emergency disaster loans and on its single-family housing loans. Conversely, it has no limits on loans in other programs, such as those made in the water and waste disposal loan program.

## A Lower Repayment Guarantee Could Reduce the Level of RUS' Vulnerability to Losses

The RE Act allows RUS to guarantee repayment on electricity and telecommunications loans made by the FFB or other lenders. The act also requires that the guarantee be 100 percent. As of June 30, 1997, RUS had about $19.8 billion in guaranteed loan debt on which it has full risk exposure. Almost $14 billion of this amount was outstanding principal on original loans with RUS guarantees, and about $5.8 billion was on restructured loans. The lenders that made the loans—the FFB and a few commercial lenders—have no risk exposure. Providing a guarantee of less than 100 percent could reduce RUS' vulnerability to losses from these two credit programs. However, because all guaranteed loans in recent years have been made by the FFB, the risk to the federal government as a whole would not be reduced if the FFB continues to be the sole source of loan funds.

According to FFB officials, providing a guarantee of less than 100 percent could cause the FFB to stop making electricity and telecommunications loans because it only participates in lending programs when there is full security on its loans. Even if the guarantee remains unchanged, however, a provision in the recently enacted Balanced Budget Act of 1997 (P.L. 105-33, Aug. 5, 1997) may affect the FFB's willingness to continue making loans to electricity and telecommunications borrowers. The act provides that the surcharge on FFB loans, which is one-eighth of 1 percent over the Treasury's cost of borrowing, is to be deposited in the RUS account held by the Treasury and used to finance the cost of these two loan programs. FFB officials told us that this surcharge has generally offset its administrative

cost of participating in RUS' programs. The act also provides that the FFB can require RUS to reimburse it for the administrative expenses incurred that are attributable to the loans.

All loans that received RUS' guarantees during fiscal years 1994 through June 30, 1997, were made by the FFB. While the RE Act gives the borrower the option of selecting the FFB or a commercial lender, RUS officials told us that borrowers have selected the FFB because it offers lower interest rates. According to FFB officials, some borrowers also turn to the FFB because the large amount of money they need is probably more than commercial lenders would provide. While this may be true, our analysis of guaranteed loans made by the FFB and commercial lenders showed that some commercial lenders provided large-dollar loans and that the FFB made a number of small-dollar loans that could have been funded by commercial lenders. For example, as of June 30, 1997, 10 power supply borrowers had outstanding guaranteed loans from commercial lenders that had been made before the start of fiscal year 1994—six of these had received loans for more than $100 million each. In addition, even though the FFB is thought of as a high-dollar lender, RUS' records showed that 9 of the 36 electricity loans and 20 of the 29 telecommunications loans made by the FFB during fiscal years 1994 through June 30, 1997, were for less than $5 million.

USDA has less risk exposure when guaranteeing loans in other rural credit programs, such as farm ownership and operations, single-family housing, community facilities, business and industry, and water and waste disposal loans. With each of these loan programs, the maximum allowable loan guarantee is generally 90 percent. In some cases, such as RUS' water and waste disposal loans, the guarantees are usually at 80 percent.

## Establishing Policies to Preclude Loans to Certain Risky Borrowers Would Reduce Future Exposure to Loss

A borrower that is delinquent on an electricity or a telecommunications loan is not prohibited by the RE Act or by RUS' regulations from obtaining an additional loan. Likewise, a borrower that has caused RUS to incur loan losses is not prohibited from obtaining another loan. Our review of RUS' loan approval records showed that no delinquent borrower or one that caused prior losses received loans during fiscal years 1994 through June 30, 1997. While RUS did not make or guarantee loans to such borrowers during this period, we believe that the agency's ability to do so is an area of concern that could, if loans were made, contribute to future exposure to loss. Prohibiting loans to such risky borrowers is a way of

ensuring that RUS does not add to its vulnerability in operating these two credit programs.

RUS has had few delinquent borrowers and borrowers that have caused it to incur losses in recent years. Specifically, as of June 30, 1997, three electricity loan borrowers were delinquent; no telecommunications loan borrowers were delinquent. Additionally, during fiscal years 1994 through June 30, 1997, RUS wrote off the debt of five electricity loan borrowers, which resulted in losses to RUS; no telecommunications borrowers had loans written off.

RUS' electricity and telecommunications loan officials told us that a borrower has to be in good standing on its existing debts in order to obtain a RUS loan. An official in the telecommunications program said that it would be highly unlikely for an additional loan to be made to a borrower that had caused a loss because RUS would have pursued foreclosure proceedings against the borrower and would have required disposal of assets as a part of the settlement that resulted in the loss. Nonetheless, officials in both programs acknowledged that their regulations do not prohibit loans to delinquent borrowers or to those that have caused prior losses.

On September 26, 1997, RUS published a change to its electricity loan regulations that, rather than denying loans to borrowers that have had debts written off, provides guidance on what such borrowers need to provide as a condition for obtaining another loan. RUS stated that in considering a loan request from a borrower whose debt had been settled, including debt written off, the borrower would be required to demonstrate evidence of financial support for the amount of the requested loan. This support could include increasing the level of the applicant's equity or a guarantee of debt repayment, either from the applicant's members (in the case of a power supply borrower) or from a third party.

Prior to the Federal Agriculture Improvement and Reform Act of 1996 (P.L. 104-127, Apr. 4, 1996), USDA provided some loans in another rural credit program—farm loans—to delinquent borrowers and to those whose prior performance resulted in losses for USDA. However, because of concerns about the fiscal prudence of making loans to such borrowers, coupled with the high level of delinquencies and losses that USDA had experienced, the Congress enacted provisions in that act that generally prohibit farm loans to such borrowers.

## Commercial Lending for Rural Electricity and Telecommunications Purposes

RUS is not the only provider of credit to rural utilities. Two commercial lenders have a significant level of lending activity for rural electricity and telecommunications purposes: (1) the National Rural Utilities Cooperative Finance Corporation (CFC) and its various affiliated lending organizations and (2) the Farm Credit System (FCS). These two commercial lenders had a combined total of $13.1 billion in outstanding principal on loans for rural electricity and telecommunications purposes as of June 30, 1997.

CFC provides electricity loans to its owners, such as distribution cooperatives and power suppliers. CFC's loans parallel RUS' lending—that is, loans are made for financing the construction, improvement, and repair of electricity systems. Loans are also made for other purposes, such as financing operations and business activities related to the borrowers' electricity operations, including acquiring office buildings and equipment. One of CFC's affiliates—the Guaranty Funding Cooperative—made electricity loans to CFC's owners for refinancing their outstanding FFB debt. Another affiliate—the Rural Telephone Finance Cooperative (RTFC)—makes loans to rural telephone systems that are eligible to participate in RUS' telecommunications program. While RTFC finances some infrastructure development, most of its financing is for activities that RUS is not involved in, such as cellular telephone operations, or is involved in to only a limited extent, such as the acquisition of local telephone exchanges.

FCS lends primarily to agricultural producers and agricultural cooperatives. However, two FCS banks—CoBank and the St. Paul (Minnesota) Bank for Cooperatives—also make loans to rural utilities. CoBank is FCS' national bank for lending to rural utility systems and cooperatives. The St. Paul Bank, although it also has a national charter, provides similar lending to borrowers located primarily in four upper midwestern states (Michigan, Minnesota, North Dakota, and Wisconsin). Both banks provide electricity and telecommunications loans to RUS' borrowers, rural utility systems that are eligible to borrow from RUS, and the subsidiary organizations of these borrowers or other eligible entities. As with CFC and RTFC, the loans from these banks parallel RUS' infrastructure lending and are also made for other activities that RUS is not involved in or is involved in to only a limited extent.

These lenders and their affiliated organizations had about $10.4 billion in outstanding principal on electricity loans and about $2.8 billion in outstanding principal on telecommunications loans as of June 30, 1997. As

table 5 shows, CFC's loans accounted for the greatest portion of this amount.

**Table 5: Amount of Outstanding Principal on Electricity and Telecommunications Loans Held by Various Commercial Lenders, as of June 30, 1997**

Dollars in millions

| Lender | Electricity loans | Telecommunications loans |
|---|---|---|
| CFC[a] | $7,766.4 | $0 |
| RTFC | 0 | 1,123.2 |
| CoBank | 2,144.5 | 1,292.9 |
| St. Paul Bank | 454.2 | 336.0 |
| **Total** | **$10,365.1** | **$2,752.1** |

[a]Includes loans made by CFC to distribution and power supply systems and loans made by CFC's Guaranty Funding Cooperative for refinancing FFB debt.

Source: Financial reports provided by each lender to GAO.

Additionally, the information provided to us by each of these lenders shows that their electricity and telecommunications portfolios were generally financially sound. For example, less than 1 percent of CFC's $7.8 billion electricity loan portfolio was owed by delinquent borrowers. Furthermore, since its inception in 1969 through the end of May 1997, CFC wrote off a total of $28.4 million in electricity loans. According to CFC and RTFC officials, no borrowers with RTFC telecommunications loans were delinquent, and no such loans had been written off since RTFC's inception in 1987.

CoBank and the St. Paul Bank had similar experiences. Specifically, all borrowers with electricity and telecommunications loans were current on their loan repayment. In addition, according to their officials, CoBank has not written off any electricity or telecommunications loans in recent years, and the St. Paul Bank has never written off such a loan.

# Conclusions and Options for Congressional Consideration

RUS has had a long and successful role in contributing to the development of the utility infrastructure in the nation's rural areas. However, RUS is now at a significant crossroads. The size of the population in the areas served by many of RUS' borrowers has changed over time, as have the financial resources available to borrowers. Furthermore, spurred by recent legislative and/or technological changes, increasing competition in the electricity and telecommunications industries may have an impact on many of the agency's borrowers. We recognize that difficult decisions are

necessary to improve the effectiveness and reduce the cost of these loan programs as well as to decrease RUS' vulnerability to losses in operating the programs. It may be hard to accomplish all these objectives simultaneously.

Recognizing that there would be trade-offs with any changes to RUS' electricity and telecommunications loan programs, the Congress has a number of options that it could consider in its deliberations on the future of RUS' programs, including the following:

- To ensure that RUS' assistance is targeted to rural areas with sparse populations, the Congress could apply a population threshold test to the service areas of borrowers who apply for any RUS loan—not only for initial loans but also for any subsequent loans.
- To target subsidized direct loans to borrowers in need of RUS' assistance and to control program costs, the Congress could make financial tests a part of the eligibility criteria for the various types of direct loans in both programs. Additionally, cost-of-money rate loans could be established in the electricity program for borrowers that do not meet the financial tests for municipal rate loans. Furthermore, the interest rates for municipal rate loans and cost-of-money rate loans, if established in the electricity program, could be set no lower than the rate on a hardship rate loan. Finally, a test could be established to require a borrower to seek commercial credit as a condition for RUS' assistance.
- To assist in moving financially healthy borrowers with direct loans to the commercial sector, the Congress could have RUS establish a graduation program to require borrowers to attempt to have their outstanding direct loans refinanced by commercial credit sources.
- To limit the level of the agency's vulnerability to losses, the Congress could set limits on the total amount of money that RUS provides or guarantees on any one loan and on the total amount of outstanding debt that any one borrower can accumulate through a combination of loans.
- To further control RUS' vulnerability to losses on guaranteed loans, the Congress could set the repayment provision at less than 100 percent.
- To ensure that RUS does not increase its vulnerability to losses by making loans to certain risky borrowers, the Congress could provide guidance specifying that a borrower is ineligible for a direct or a guaranteed loan if the borrower is delinquent or if the borrower has caused RUS to incur a prior loan loss.

## Agency Comments and Our Evaluation

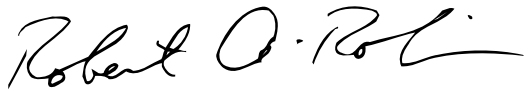
We provided a draft of this report to USDA for its review and comment. In summary, USDA expressed concern over several of the options presented in the report, particularly those involving targeting loans, graduating borrowers, and limiting borrowers' loan and debt levels. In regard to targeting loans, USDA noted, among other things, that a borrower serving a combination of rural and nonrural customers is probably financially stronger than a borrower that does not serve a diverse customer base. We agree. Our point, however, is that some borrowers serve large numbers of customers, including some in nonrural areas, and that the Congress may want to target loans to borrowers who serve rural areas more exclusively. USDA's discomfort over options involving graduating borrowers and limiting borrowers' loan and debt levels reflects, in part, concern over possible detrimental impacts that these options may have on borrowers or their service to rural areas. It is difficult to predict the extent to which USDA's concerns would be realized if these options were to be put into effect. However, we believe that the possible impacts to service in rural areas should be considered in developing specific implementation plans for these or any other options that the Congress may choose to act upon.

Overall, USDA's comments provide additional perspectives on issues discussed in the report and highlight the difficulties that face policymakers as they consider options for improving the effectiveness and efficiency while reducing the cost to the government of RUS' electricity and telecommunications loan programs. A complete presentation of USDA's comments and our response is provided in appendix III.

We performed our review of the operations of RUS' electricity and telecommunications loan programs from May 1997 through December 1997 in accordance with generally accepted government auditing standards. Our scope and methodology are discussed in appendix IV.

As agreed, unless you publicly announce its contents earlier, we plan no further distribution of this report until 14 days from the date of this letter. At that time, we will send copies of this report to the appropriate Senate and House committees; interested Members of Congress; the Secretary of Agriculture; the Administrator of RUS; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Please call me at (202) 512-5138 if you or your staff have any questions. Major contributors to this report are listed in appendix V.



Robert A. Robinson
Director, Food and
Agriculture Issues

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## Abbreviations

| | |
|---|---|
| CFC | National Rural Utilities Cooperative Finance Corporation |
| FCS | Farm Credit System |
| FFB | Federal Financing Bank |
| GAO | General Accounting Office |
| REA | Rural Electrification Administration |
| RE Act | Rural Electrification Act of 1936, as amended |
| RTB | Rural Telephone Bank |
| RTFC | Rural Telephone Finance Cooperative |
| RUS | Rural Utilities Service |
| TIER | times-interest-earned ratio |
| USDA | U.S. Department of Agriculture |

# Financial Information on Borrowers That Received Loans in Recent Years

This appendix contains information on the financial characteristics of borrowers that obtained electricity and telecommunications loans during calendar years 1994 through June 30, 1997.[1] Table I.1 shows that the overwhelming majority of the borrowers had equity of $1 million or more at the end of the year prior to receiving the loans. Table I.2 shows that most of these borrowers made a profit of at least $100,000 in the year prior to receiving the loans. Tables I.3, I.4, and I.5 show that the current ratios, debt-to-asset ratios, and times-interest-earned ratios of the borrowers were generally favorable prior to receiving the loans.

**Table I.1: Number of Electricity and Telecommunications Borrowers That Obtained Loans During Calendar Years 1994 Through June 30, 1997, by Range of Equity Prior to Receiving the Loans**

| | Range of equity | | | | | |
|---|---|---|---|---|---|---|
| **Type of borrower** | **Less than $0** | **$0 to less than $100,000** | **$100,000 to less than $1 million** | **$1 million to less than $10 million** | **$10 million to less than $100 million** | **$100 million or more** |
| Electricity distribution borrowers | 1 | 1 | 2 | 194 | 229 | 5 |
| Electricity power supply borrowers | 1 | 0 | 0 | 0 | 16 | 3 |
| Telecommunications borrowers | 1 | 1 | 17 | 109 | 40 | 0 |
| **Total** | **3** | **2** | **19** | **303** | **285** | **8** |

Note: Equity, or net worth, is the difference between assets and liabilities and includes capital stock and/or patronage capital, memberships, and capital credits.

Source: GAO's analysis of RUS' automated databases, which contain financial information submitted by electricity and telecommunications borrowers.

[1]This appendix covers borrowers that obtained loans from the Rural Utilities Service (RUS) during calendar years 1994 through June 30, 1997, and for which RUS' databases contained financial information for the year prior to the one in which the loans were made.

**Table I.2: Number of Electricity and Telecommunications Borrowers That Obtained Loans During Calendar Years 1994 Through June 30, 1997, by Range of Profit Prior to Receiving the Loans**

| | Range of profit | | | | | |
|---|---|---|---|---|---|---|
| Type of borrower | Less than $0 | $0 to less than $100,000 | $100,000 to less than $1 million | $1 million to less than $10 million | $10 million to less than $100 million | $100 million or more |
| Electricity distribution borrowers | 12 | 13 | 246 | 158 | 3 | 0 |
| Electricity power supply borrowers | 0 | 0 | 2 | 16 | 2 | 0 |
| Telecommunications borrowers | 4 | 12 | 103 | 46 | 3 | 0 |
| **Total** | **16** | **25** | **351** | **220** | **8** | **0** |

Note: Profit, or net income, is the difference between revenues and expenses and includes operating income plus or minus nonoperating income, capital credits, and fixed charges (e.g., interest on funded debt and other interest expenses). RUS refers to the profits made by electricity and telecommunications loan borrowers that are nonprofit cooperatives as "net margins" and to the losses as "deficits in net margins."

Source: GAO's analysis of RUS' automated databases, which contain financial information submitted by electricity and telecommunications borrowers.

**Table I.3: Number of Electricity and Telecommunications Borrowers That Obtained Loans During Calendar Years 1994 Through June 30, 1997, by Range of Current Ratio Prior to Receiving the Loans**

| | Range of current ratio | | | |
|---|---|---|---|---|
| Type of borrower | Less than one time | Up to two times | Two to up to five times | Five or more times |
| Electricity distribution borrowers | 73 | 188 | 145 | 26 |
| Electricity power supply borrowers | 1 | 5 | 14 | 0 |
| Telecommunications borrowers | 15 | 19 | 83 | 51 |
| **Total** | **89** | **212** | **242** | **77** |

Note: The current ratio is a measure showing the extent to which a borrower has sufficient current assets to cover its current liabilities. It is computed by dividing a borrower's current assets by current liabilities.

Source: GAO's analysis of RUS' automated databases, which contain financial information submitted by electricity and telecommunications borrowers.

**Table I.4: Number of Electricity and Telecommunications Borrowers That Obtained Loans During Calendar Years 1994 Through June 30, 1997, by Range of Debt-to-Asset Ratio Prior to Receiving the Loans**

| | Range of debt-to-asset ratio | | | |
|---|---|---|---|---|
| Type of borrower | 100 percent or more | 71 to 99 percent | 41 to 70 percent | 40 percent or less |
| Electricity distribution borrowers | 1 | 45 | 353 | 33 |
| Electricity power supply borrowers | 1 | 15 | 4 | 0 |
| Telecommunications borrowers | 1 | 28 | 113 | 26 |
| **Total** | **3** | **88** | **470** | **59** |

Note: The debt-to-asset ratio shows the extent to which a borrower has sufficient assets to cover all of its debt. It is computed by dividing a borrower's total debt by total assets.

Source: GAO's analysis of RUS' automated databases, which contain financial information submitted by electricity and telecommunications borrowers.

**Table I.5: Number of Electricity and Telecommunications Borrowers That Obtained Loans During Calendar Years 1994 Through June 30, 1997, by Range of Times-Interest-Earned Ratio Prior to Receiving the Loans**

| | Range of times-interest-earned ratio | | | |
|---|---|---|---|---|
| Type of borrower | Less than one time | Up to two times | Two to up to five times | Five times or more |
| Electricity distribution borrowers | 11 | 146 | 249 | 26 |
| Electricity power supply borrowers | 0 | 17 | 1 | 2 |
| Telecommunications borrowers | 4 | 18 | 95 | 51 |
| **Total** | **15** | **181** | **345** | **79** |

Note: The times-interest-earned ratio shows the extent to which a borrower can pay its annual interest expenses from its net income. It is computed by dividing the sum of a borrower's total net income and interest on debt by interest on debt.

Source: GAO's analysis of RUS' automated databases, which contain financial information submitted by electricity and telecommunications borrowers.

# Information on the Value of Loans Made in Recent Years

This appendix contains information on the dollar value of electricity and telecommunications loans made to borrowers during fiscal years 1994 through June 30, 1997. Table II.1 shows that while most of the 926 loans approved during this period were made for less than $10 million, 113 loans were for $10 million or more.

**Table II.1: Number of Electricity and Telecommunications Loans Approved, Fiscal Years 1994 Through June 30, 1997, by Range of Loan Amounts**

| | Range of loan amounts | | | | | |
|---|---|---|---|---|---|---|
| **Program and loan type** | **Less than $1 million** | **$1 million to less than $5 million** | **$5 million to less than $10 million** | **$10 million to less than $20 million** | **$20 million to less than $50 million** | **$50 million or more** |
| **Electricity** | | | | | | |
| Direct hardship rate | 12 | 68 | 11 | 5 | 1 | 0 |
| Direct municipal rate | 43 | 232 | 76 | 42 | 8 | 0 |
| Guaranteed | 2 | 7 | 6 | 10 | 6 | 5 |
| **Total** | **57** | **307** | **93** | **57** | **15** | **5** |
| **Telecommunications** | | | | | | |
| Direct hardship rate | 3 | 18 | 27 | 1 | 0 | 0 |
| Direct cost-of-money rate | 26 | 82 | 28 | 18 | 3 | 0 |
| Direct Rural Telephone Bank | 39 | 79 | 30 | 8 | 1 | 0 |
| Guaranteed | 13 | 7 | 4 | 2 | 1 | 2 |
| **Total** | **81** | **186** | **89** | **29** | **5** | **2** |

Source: GAO's analysis of RUS' loan records.

# Comments From the U.S. Department of Agriculture

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

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

DEC 18

Mr. Robert A. Robinson
Director, Food and Agriculture Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Robinson:

We appreciate the opportunity to review and comment on the draft General Accounting Office (GAO) report entitled Rural Utilities Service: Opportunities to Operate Electricity and Telecommunications Loan Programs More Effectively.

See comment 1.
See comment 2.

The report offers a number of recommendations to make these loan programs more effective and less costly. The report mentions a portion of 7 U.S.C. 930. We believe that your abbreviated version of the provision does not accurately reflect the meaning of the provision. The provision in its entirety states:

> **"It is hereby declared to be the policy of the Congress that adequate funds should be made available to rural electric and telephone systems through direct, insured and guaranteed loans at interest rates which will allow them to achieve the objectives of the Rural Electrification Act of 1936, as amended,** and that such rural electric and telephone systems should be encouraged and assisted to develop their resources and ability to achieve the financial strength needed to enable them to satisfy their credit needs from their own financial organizations and other sources at reasonable rates and terms consistent with the loan applicant's ability to pay and achievement of the Act's objectives."

We recognize that the goals of the report: "(1) make the electricity and telecommunications loan programs more effective and less costly for the government and (2) decrease RUS' vulnerability to loan losses" are, to some extent, contradictory. Financially stronger borrowers have easier access to reasonably priced private sector capital, while borrowers in greater need of a government subsidy are poorer credit risks. Nonetheless, these goals can be reconciled in order to support the electric and telecommunications infrastructure that is vital for rural communities, while maintaining the integrity of the RUS loan portfolio.

**General Comments**

Since the report recommends fundamental changes in the RE Act, we believe that it is important for its readers to have a comprehensive understanding of the current characteristic of RUS borrowers and the uncertainty surrounding the industries in which they operate.

Rural communities

The Rural Electrification Act of 1936, (7 U.S.C. 901 *et seq.*) (RE Act) is intended to benefit rural communities by supporting their electric and telecommunications infrastructure. The residents of these communities are the true beneficiaries of the RE Act. The benefits of low interest loans are reflected in rates to residential electric and telecommunications customers in rural areas, and in

rates for commercial and industrial service that make rural communities attractive to business opportunities.

See comment 3.

The implication that a change in the composition of a borrower's service territory should disqualify that borrower from participating in the RUS loan programs is not fundamentally sound. Many borrowers' service territories include both rural and non-rural customers. This diversity of customer base contributes to the financial health of the utility, helps maintain reasonable rates for rural customers, and reduces the risk of RUS loans. We believe that this diversity of customer base will be critically important to the long-term financial stability of borrowers as their industries become more competitive at the local level.

Congress recognized this changing nature of borrower when it enacted the Rural Electrification Loan Restructuring Act of 1993. It set interest rate eligibility based upon per capita income of consumers, rate disparity, and consumer density. This Act also revised the definition of "rural" for new borrowers of both the electric and telecommunications loan programs. We suggest, therefore, that caution be used in strictly applying classifications such as rural, urban, and metropolitan to service territories as the measure of whether an RUS borrower is achieving the Congressionally stated policy objective of the RE Act.

The changing environment of the electric and telecommunications industries

See comment 4.

The movement to a more competitive environment in both the electric and telecommunications industries substantially increases risk both for utilities and for customers in areas that are seen as less profitable to serve. New telecommunications regulations take effect January 1998, and their impacts will be felt gradually. The impacts of restructure of the wholesale end of the electric industry are just beginning to be felt. Statutes and regulations to make the retail end of the electric industry more competitive are under development at both the federal and state levels. The increased risk of both industries affects capital markets and the ability of utilities to attract private sector capital. RUS urges, therefore, that any recommended changes to RUS loan programs take this volatility into consideration.

The nature of RUS borrowers

See comment 5.

The report makes repeated mention of what it terms borrowers' "profit". The repeated use of the term "profits" shows a lack of understanding of the characteristics of cooperative organizations. In fact, most electric borrowers and many telecommunications borrowers are cooperatives owned by the consumers they serve. Rather than earning profits that yield dividends to shareholders, these cooperatives allocate their "margins" earned during any reporting year as patronage capital to their members. These patronage capital allocations result in *de facto* rate reductions to the cooperative members, reducing the cooperative's operations to a break-even level. The benefits of these patronage allocations, therefore, flow to the consumers/subscribers who are, coincidentally, the intended beneficiaries of the RUS programs. The member-sourced earnings of RUS cooperative borrowers are not considered profits by the Internal Revenue Service and as such, are exempt from federal income tax.

**Opportunities to Make the Loan Programs More Effective and Less Costly**

The report states that "opportunities exist to make the loan programs more effective and less costly". We have analyzed the report's conclusions and recommendations, along with the underlying premises and data, and we offer the following:

Loans are sometimes made to borrowers serving large customer populations

See comment 6.

The report bases its findings to a great extent on significant mischaracterizations of RUS borrowers. While a few RUS borrowers do, in fact, serve large customer populations, most borrowers serve small subscriber populations and are considered small businesses according to the size standards established by the Small Business Administration (SBA). The telecommunications borrower specifically cited as an example illustrates this point. The borrower serves a city and the surrounding sparsely populated rural area. RUS financing was not used to provide service to the city because it does not meet the Urban/Rural test of the RE Act. The only telecommunications plant financed by RUS was that dedicated to serving rural subscribers outside the city. Absent RUS financing, prudent business practice would dictate that this borrower invest its higher cost capital in the areas in which it will earn the best return - the high density urban area. Ultimately, rural area service would be improved only after the higher density city subscribers, if at all. Under the Telecommunications Act of 1996, as competition comes to rural areas, the pressure to invest in competitive markets will place even greater pressure on the availability of capital to improve service in rural areas. It is important to note that over 85 percent of RUS' telecommunications borrowers have less than 10,000 subscribers, nearly 70 percent serves less than 5,000, and the medium number of subscribers per borrower is less than 2,800.

See comment 7.

We strongly disagree with the use of customer size as a criterion for determining eligibility for loans. Large customer population alone is not an accurate measure of a borrower's financial strength or its ability to attract capital. The average RUS electric borrower serves between 5 and 6 consumers per mile of distribution line; while the average investor owned utility (IOU) serves about 35 consumers per mile. Because the electric and telecommunications industries are highly capital intensive, a utility that serves a large number of mostly residential consumers over a large geographic area may not be able to achieve the economies of scale necessary to attract steady infusions of private sector capital at interest rates that can support reasonable electric and telecommunications rates for rural consumers.

Loans with subsidized interest rates are made to financially healthy borrowers that may not need RUS' assistance

The RUS electric and telecommunications programs provide a financial incentive to encourage rural electric and telecommunications utilities to provide modern service in areas that otherwise might not be well served, or served at all. RUS is, therefore, quite different from other Federal lending programs, particularly the single-family housing program. High financing costs of capital investments in sparsely populated areas may inhibit the construction of necessary facilities and/or dramatically increase electric and telecommunications rates. It is critical, therefore, to the provision of reliable service that all rural borrowers, including those that are financially healthy, be afforded the opportunity to obtain Federal financing to make improvements in rural service areas.

See comment 8.

The report notes that many RUS borrowers have high equity levels and favorable debt to asset ratios and alleges that RUS borrowers do not invest significant amounts of their own funds in plant nor obtain non-Federal financing when opportunities exist. Many RUS borrowers maintain these somewhat favorable statistics because they have, in fact, invested considerable amounts of their internally generated capital in plant. In 1996 alone, a total of $1.5 billion was expended by RUS borrowers on telecommunications plant, of which RUS financing accounted for only $261 million.

By investing the cash generated by operating margins in plant, a borrower's debt-to-asset ratio improves as does its ability to generate positive margins. Plant that is financed by internally generated funds is, by definition, debt free thereby alleviating the impact that additional interest expense would have on a borrower's margins while increasing the borrower's equity. Equity, it

See comment 9.

should be noted, is a measure of an entity's operations and is not cash, as the report seems to imply.

See comment 10.

The debt to asset ratio, (or similar measures of leverage such as equity to assets, or debt to equity) is certainly a valuable component of an analysis of creditworthiness but only when interpreted correctly. In evaluating creditworthiness, private sector lenders compare loan applicants to industry benchmarks. The report discusses debt-to-asset ratios for borrowers that obtained loans between 1994 and 1997. The figure cited is the ratio prior to obtaining the new debt, and the report implies that a debt to asset ratio of less than 70 percent is looked upon favorably by lenders. Comparisons to other electric utilities, however, show otherwise. DOE figures show that the average debt to equity ratio for IOU's is about 48 percent. [1] Virtually all IOU's are vertically integrated. RUS data for the same year shows that distribution borrowers had an average debt to asset ratio of about 40 percent, and G&T's about 70 percent. In the light of the IOU benchmarks, the ratios for RUS borrowers, even if the ratios are blended as a surrogate for vertical integration, do not seem as favorable. By this measure RUS borrowers have a distinct disadvantage in capital markets.

See comment 11.

Finally, the current ratio can hardly be considered an appropriate tool for measuring ability to obtain long-term debt. A ratio that indicates to what extent current assets are available to meet current obligations simply does not demonstrate a borrower's long-term borrowing capability.

A graduation program could assist in moving financially healthy direct loan borrowers to commercial credit

See comment 12.

The report correctly notes that the RE Act offers electric borrowers the opportunity to voluntarily graduate out of the direct loan program by prepaying direct loans at a discount. It is important to note that the discounted value is calculated on a net present value basis thereby resulting in no cost to the Government. To date, 115 borrowers have prepaid their loans and we expect that there will be more. Borrowers who take advantage of this opportunity are ineligible for direct loans for 10 years.

See comment 13.

Specifically, the electric borrower cited in the report to support GAO's recommendation of forced graduation is, in fact, voluntarily moving away from the RUS program. RUS has not advanced loan funds to this borrower since 1975, over 22 years ago. The borrower has been repaying its debt and now owes RUS only $128,000. Its total long-term debt from all sources is approximately $145,725 and interest on all long-term debt for 1996 was only $3,211. This borrower has achieved a high TIER and current ratio, and high levels of equity by avoiding all financial leverage, a rare feat, indeed, in the electric industry, or any industry today. By graduating itself from all lending programs, this borrower is truly an anomaly. The medium TIER for electric borrowers in the United States and in this borrower's state are 2.44 and 2.62, respectively.

A recent RUS analysis of borrowers who graduated out of RUS under this provision shows two significant trends. First, these borrowers tend to be stronger according to a number of measures. They are typically characterized by: ability to realize economies of scale measured by high consumer density and kWh sales per mile of line; size measured by larger number of consumers (as noted above, one of the report's suggested criteria for measuring strength), total kWh sold, and total utility plant; and newer plant. Interestingly, equity as a percent of total assets seems to be almost the same for borrowers who graduated and borrowers that did not. Also, most of these

[1] Financial Statistics of Major U.S. Investor-Owned Electric Utilities 1995, DOE/EIA-0437(95)/1, Department of Energy, Table 29.

borrowers serve in states where electric rates are at or below the national average, and their territories show higher load growth.

Finally, while these graduated borrowers are not eligible for direct RUS loans for 10 years, the law leaves them the option of applying for a loan guarantee. As the report points out, the lender is almost always the Federal Financing Bank (FFB), part of the Treasury Department. The interest rate is one-eighth of one percent above Treasury's cost of borrowing, and RUS guarantees 100 percent of the loan. In other words, if these graduated borrowers find that private sector capital is no longer affordable, the RE Act offers a backstop.

Similarly, recent lending activity indicates that a number of RUS telecommunications borrowers have sought financing through non-Federal sources. Borrowers are, in fact, seeking alternative financing through CoBank and/or the Rural Telephone Finance Cooperative as indicated in the GAO report. We believe that this voluntary graduation protects rural communities against the capital risks inherent in the restructuring of the industry.

See comment 14.

We are extremely concerned about requiring electric and telecommunications borrowers to refinance their direct loans with private sector financing at this time. In contrast to the relatively stable operating environment of the water and waste disposal program that currently graduates borrowers, the operating environment of the electric and telecommunications industries is highly volatile. The Federal Energy Regulatory Commission is implementing wholesale competition in the electric industry, and many provisions and impacts of wholesale restructuring are not yet clear. At the same time, the Federal Communications Commission (FCC) is implementing the Telecommunications Act of 1996 which will have a dramatic impact on revenue streams for rural telecommunications providers.

RUS direct loans for electric infrastructure are generally available only to borrowers that serve at retail, and restructuring of the retail side of the electric industry has barely begun. The 105th Congress has already seen five bills introduced in the Senate and seven in the House that would, in some form or another: allow, promote or require retail competition; revise or remove restrictions on utility holding companies; institute new requirements on sources of energy sold; or otherwise profoundly alter the industry. In a few states retail choice of electric supplier will be available to all consumers in a few months. Other states are still exploring options.

See comment 15.

While not mentioned in the report, the Telecommunications Act of 1996 will have a profound effect on the telecommunications industry. RUS is closely following the FCC as it moves toward implementing the Telecommunications Act, and believes that rural telecommunications service providers will be affected in at least these ways. RUS telecommunications borrowers receive, on average, 65 percent of their revenues from long distance access charges and cost pooling; however, nationwide, telecommunications service providers receive only 44 percent of their revenues from these sources. The Telecommunications Act will change the way in which revenues from these sources are collected and distributed. Access charges will decline at a controlled rate and cost pooling (the current method for collecting and disbursing funds to cover high cost service) will be completely restructured. The rulemaking process intended to design the new universal service cost pooling support mechanism is schedule to begin in 1998; however, until that mechanism is operational, the degree of negative impact on borrowers' revenue streams cannot be fully determined.

While small rural telecommunications companies may be protected (depending upon the policies of their state regulatory commissions) in the short-term from competition in their service areas, competition will ultimately come, in some form, to all areas of the nation. Initially, competition will most likely come from another service provider who will attempt to serve the lowest cost subscribers in an area. This will leave RUS borrowers with only their high cost subscribers to

serve, thereby reducing the density of the service area and increasing the average cost per subscriber.

Since the debate over retail choice in the electric industry has barely begun, impacts are even more uncertain. We believe that this uncertainty will be reflected in higher costs of private sector capital for electric and telecommunications utilities. Decreasing revenues and increasing costs will strain rural service providers and may endanger universal service. Forcing direct loan borrowers to private sector financing during this period of uncertainty may leave them paying extremely high interest rates that would be directly translated into higher electric rates for rural consumers. Since the vast majority of these borrowers are, as noted above, cooperatives, they cannot raise equity capital by selling stock. Since they are small businesses, as well, they may lack the large cash flow cushion that can protect large businesses against such "sticker shock." Even borrowers that have been historically strong could be left with no alternative other than raising rural service rates.

**Opportunities to Decrease RUS' Vulnerability to Loan Losses**

The report made several recommendations for decreasing RUS' vulnerability to loan losses: "(1) limit loan size and total amount of debt outstanding to a borrower, (2) reduce loan guarantees from 100 percent and (3) establish policies to preclude loans to risky borrowers. Second only to RUS' mission of financing high quality electric and telecommunications service to rural consumers reasonable rates, is its concern for the creditworthiness of its borrowers and the security of its loans. It is important to note that the telecommunications program, based upon its policies and procedures currently in place, has an outstanding record of loan repayments - zero defaults since its inception. Equally important to consider is the fact that the majority of loan losses in the electric program arise from investments in ill-fated nuclear plants that were either constructed at costs substantially higher than initial projections or totally abandoned during the construction phase.

See comment 16.

Loan and debt limits could reduce RUS' vulnerability to losses

See comment 17.

We do not agree that loan limits equate to a reduction in vulnerability to loan losses. RUS cannot make a direct loan or loan guarantee unless the agency determines that the borrower will be able to repay the loan according to its terms and conditions, and that the security for the loan is adequate. These determinations are based on the borrower's past performance, its management and operating environment at the time of loan approval, and projections of load growth and financial performance. Applications for electric loans include long-range financial forecasts as well as engineering studies of facilities that will be constructed with loan funds. The requirement that security for a loan be adequate effectively limits the borrower's total amount of secured debt.

See comment 18.

Lending limits also constrain a borrower's ability to take advantage of certain economies that arise from system-wide improvements. A single loan may finance the upgrading and improvement of an entire electric or telecommunications system. All pertinent plant could be constructed under a single contract under one simplified competitive bidding process. This method is, by far, the most efficient way for small utilities to construct plant. If loan limits were imposed, system-wide construction would take place only in small segments thereby significantly increasing the cost to serve rural subscribers. Increased subscriber costs are certainly not in the best interest of rural ratepayers, rural electric or telecommunications service providers, or the Federal lending programs that finance such service.

See comment 19.



Establishing policies to preclude loans to certain risky borrowers would reduce future exposure to loss

We believe that this recommendation is based on faulty premises. The rule[2] cited in the report implements the new statutory authority of the Secretary of Agriculture to compromise, adjust, reduce, or charge off debts or claims owed to the government. The rule adequately addresses the issues raised in the report by requiring credit support in the full amount of the loan as a condition of any subsequent loan.

**Electric Program Issues**

Impacts of the electric loan program in maintaining electric infrastructure

The electric loan program provides an efficient and effective use of taxpayer funds to support electric infrastructure. The subsidy amounts cited in the report actually support relatively high lending levels. The total subsidy for fiscal years 1994 through 1996 for electric hardship rate loans was $49.6 million while the lending level was $273.9 billion. For municipal rate loans during this period, $148.9 million in subsidy supported lending levels of $1,489.8 billion.

This subsidy actually generates increases in electric utility plant far greater than what lending levels indicate. For example, in calendar year 1995, RUS advanced a total of $860 million in direct and guaranteed loan funds to electric borrowers. During the same year, additions to plant by electric borrowers totaled almost four times this amount, $3.3 billion. In calendar year 1996, RUS advanced $1.02 billion to borrowers, and additions to plant totaled $3.3 billion. Borrowers make up part of this difference with internally generated funds, and part with loans from non-RUS sources. In the case of municipal rate loans, most borrowers are required to obtain part of their debt financing from a supplemental source with no RUS guarantee.

Financially healthy borrowers obtain municipal rate loans at interest rates lower than rates on hardship rate loans

The report's description of the interest rate structure for municipal rate loans is generally accurate. We emphasize only that, as a general principle, short-term interest rates are lower than long-term rates. A borrower that locks in a low rate for a short term runs the risk of a sharp increase in the rate when the advance rolls over.

Moreover, the federal subsidy is based on the difference between RUS interest rates and the rate at which RUS borrows from the Treasury. While the interest rates on RUS borrowings and municipal interest rates may not rise and fall strictly in tandem, they do follow similar trends. In other words, the subsidy rate does not necessarily increase when municipal rates fall, and vice versa.

**Telecommunications Program Issues**

Nonrural Areas

RUS strongly supports its policy of making loans for service to nonrural areas when it is incidental to providing service in rural areas. In instances where telecommunications service is to be provided in a nonrural area, RUS applies a "necessary and incidental" test to determine that, without financing plant in a particular nonrural area, the rural area would suffer the consequences by receiving less or no service. In addition, when making a loan to a telecommunications borrower where funds are to used in a nonrural area, RUS conducts Urban/Rural studies to

[2] The rule, adding a new subpart Y to 7 CFR Part 1717, was published September 26, 1997, at 62 FR 50486.

determine that the majority of the benefit from the financing will be derived by the rural residents. Defining a rural area is simply not as easy as assigning a number. These policies enable RUS to apply judgment in making loans that ultimately benefit the residents in rural areas, be they rural, extremely rural, or some mixture. The goal of "universal" service can only be achieved if service is provided in areas, both rural and nonrural.

Once again, we appreciate the opportunity to review and comment on the draft report. If you wish to discuss these comments on a more detailed basis, we are available at your request. While we welcome suggestions that will improve the operational efficiency of our loan programs, any recommendations that are forthcoming should take into consideration the revolution that is taking place in both the electric and telecommunications industries. Due to the numerous uncertainties surrounding the eventual evolution of these industries, it is important the RUS lending programs remain flexible in their abilities to provide financing to ensure modern, reliable electric and telecommunications service to rural America.

Sincerely,

JILL LONG THOMPSON
Under Secretary
Rural Development

The following are GAO's comments on the U.S. Department of Agriculture's (USDA) letter dated December 18, 1997.

## GAO Comments

1. The draft reviewed by USDA contained no GAO recommendations; rather, as requested by the Senate Committee on Agriculture, Nutrition, and Forestry, it presented several options for congressional consideration and recognized that there would be tradeoffs for any option implemented.

2. Our report referenced the 7 U.S.C. 930 provision in a relatively narrowly focused discussion of how an applicant's financial health affects its eligibility to obtain RUS' loans. As a result, we had no reason to discuss the other parts of the provision that dealt with broader policy statements on the availability of RUS' loan funds. We therefore continue to believe that we cite the provision appropriately and that it indicates congressional intent that borrowers in both programs should be encouraged and assisted to use their own resources or seek credit through commercial sources to satisfy their needs.

3. We believe that changes in the composition of a borrower's service territory should be considered in determining an applicant's eligibility to participate in RUS' loan programs if the Congress is interested in targeting loans primarily to rural areas. We agree with the benefits of diversity cited by USDA—that a combination of rural and nonrural customers reduces risk and contributes to financial health. Our point is that the Congress may want to consider clarifying the level at which RUS' loans are primarily benefiting nonrural rather than rural customers.

4. We appreciate USDA's concerns about the changing environment in which RUS' borrowers operate. We recognize in the report's discussion on the continuing vulnerability to loan losses that competition may affect borrowers.

5. RUS uses net margins to refer to the bottom-line income of its cooperative borrowers; we recognize RUS' use of this term in footnote 11 in the report. Rather than use this term, however, we use profits (net income), which is more widely recognized. Profits, or net margins, and losses, or deficits in net margins, are calculated in the same manner. That is, operating revenue less operating expenses plus or minus nonoperating income/expenses, other fixed charges (including interest expense), and other income statement adjustments. We also recognize that a

cooperative's distribution of profits/margins to its members has the effect of reducing the rates that the members pay.

6. Our intention in providing information on customer populations was to show that some borrowers serve large populations—a fact that USDA acknowledges in its response. While most RUS borrowers may be serving sparsely populated areas, as USDA points out, our purpose was to report on customer populations and identify instances in which borrowers appear to be serving areas that are not sparsely populated. Regarding the example of a telecommunications loan borrower, documentation in RUS' files stated that the loan was intended to benefit the borrower's entire service area—not just its rural customers.

7. Our draft report did not suggest that customer size be a criterion for program eligibility. In fact, the report acknowledges that customer service statistics are only an indicator of population density, which, in our view, should be considered if the Congress wants to target program benefits to rural areas.

8. The draft reviewed by USDA did not discuss the extent to which borrowers invested their own funds or sought nonfederal financing. Rather, it discussed the levels of equity, profit, and various ratios for borrowers that obtained loans during calendar years 1994 through June 30, 1997.

9. The draft reviewed by the Department defines equity as total assets less total liabilities—it did not state nor attempt to imply that equity is only cash.

10. We recognize that there is some judgment involved in determining benchmarks for financial ratios. This is why we presented data on the number of RUS' borrowers having debt-to-asset ratios of 70 percent or less as well as those having debt-to-asset ratios of no more than 40 percent.

11. We agree. As the draft reviewed by USDA stated, the current ratio is a measure that shows the extent to which a borrower has sufficient current assets to cover its current liabilities. As such, it is one measure of the financial health of borrowers.

12. The draft reviewed by USDA stated that the discounted prepayment amount is the present value of a borrower's outstanding debt.

13. The borrower we use as an example in the report is one of many borrowers that appear to be candidates for commercial lenders to refinance their outstanding direct loans. As the report states, about 39 percent of RUS' electricity and telecommunications borrowers had equity of $10 million or more at the end of 1996. In addition, about 36 percent made a profit of $1 million or more in 1996.

14. We appreciate USDA's concerns about requiring borrowers to refinance their direct loans with private sector financing during a time in which the environment that the borrowers operate in is changing. However, the fact is that some borrowers appear to have such highly favorable financial characteristics that we believe a graduation program is a logical step in terms of assisting them to move to private sector financing.

15. The draft reviewed by USDA recognized that the Telecommunications Act of 1996 and the Energy Policy Act of 1992 could have either positive or negative impacts on RUS' borrowers and on the quality of the agency's portfolio. This issue is covered in the discussion on the continuing vulnerability to loan losses.

16. We agree that the telecommunications loan program has been operated very successfully. The draft reviewed by USDA stated that there were no telecommunications loans written off during the period covered by our review and that no telecommunications loans were delinquent as of June 30, 1997. We have revised the report to reflect USDA's comment concerning the losses in the electricity loan program.

17. USDA states that it does not agree that loan limits will reduce RUS' vulnerability to loan losses. We believe that limits would reduce the agency's vulnerability because individual borrowers would be restricted to a maximum amount on any one loan and on the level of debt that they could accumulate through multiple loans.

18. The extent to which these problems occur would, of course, depend on how much of a limit was placed on loans and debt. These limits could be established with the intent of balancing consideration for minimizing risk as well as optimizing operational efficiency.

19. We do not agree with USDA that the September 1997 rule adequately addresses our concerns. The rule allows borrowers whose accounts are settled, including a write-off of debt, to obtain additional loans, rather than prohibiting such borrowers from being eligible for loans.

# Objectives, Scope, and Methodology

In April 1997, we reported on the financial condition of RUS' multibillion-dollar portfolio of electricity and telecommunications loans. Subsequently, the Chairman and the Ranking Minority Member of the Senate Committee on Agriculture, Nutrition, and Forestry requested that we conduct a follow-up study focusing on RUS' program operations, specifically looking to identify ways to (1) make the electricity and telecommunications loan programs more effective and less costly for the government and (2) decrease RUS' vulnerability to loan losses. They also requested that we compile loan information on commercial lenders that have a significant level of lending for rural electricity and telecommunications purposes.

To compile information on loans and outstanding debt, we used RUS' automated loan records and various loan reports. We did not adjust the outstanding loan amounts to reflect the allowance for losses that RUS includes in its financial statements or assess the adequacy of reserves on the loans.

To address our first two objectives—ways to make the loan programs more effective and less costly for the government and to decrease RUS' vulnerability to loan losses—we interviewed officials at RUS' headquarters, including the Assistant Administrators and Deputy Assistant Administrators for Electricity and Telecommunications. We reviewed in detail the Rural Electrification Act of 1936, as amended, and its legislative history; and RUS' implementing regulations and other program operating guidance. We conducted extensive analyses of information in RUS' various automated records. First, we identified borrowers from the automated records that received loans in calendar years 1994 through June 30, 1997, and then matched those borrowers with the agency's databases containing borrower-submitted operational and financial information for the year prior to the one in which the loans were made. In addition, we categorized the borrowers that received loans by various incremental ranges of loan amounts. Second, we analyzed borrowers' financial data at the end of 1996 to determine the financial characteristics of borrowers with outstanding direct loans. Third, we analyzed information covering borrowers that prepaid their direct electricity loans at a discount during fiscal years 1994 through June 30, 1997. We also interviewed RUS' officials in Oklahoma and Missouri, and an electricity borrower and a telecommunications borrower in each of those two states.

The information on the subsidy costs of the programs for fiscal years 1994 through 1996 was obtained from USDA reports. The information on interest

rates that were available on municipal rate loan advances from January 1, 1994, through September 30, 1997, was obtained from RUS' quarterly publications in the Federal Register and/or from other RUS announcements. We also extracted from RUS' loan portfolio databases the information on borrowers that obtained advances with interest rates of less than 5 percent.

We interviewed Federal Financing Bank (FFB) officials to obtain information on the bank's participation in RUS' loan programs. We reviewed the FFB's annual financial statements and independent auditor's reports for fiscal years 1994 through 1996. We also reviewed the provisions in the Balanced Budget Act of 1997 that relate to the FFB's participation in RUS' programs.

We obtained the information on problem borrowers, including borrowers that caused losses, from interviews of RUS officials, including those in the electricity program; testimony by RUS' Administrator at a July 8, 1997, hearing before the Senate Committee on Agriculture, Nutrition, and Forestry; and the agency's financial reports and automated records.

To address our third objective—information on commercial lenders that have a significant level of lending for rural electricity and telecommunications—we interviewed RUS' loan program officials and FFB officials. We also interviewed officials with each of the private lending institutions that we identified—the National Rural Utilities Cooperative Finance Corporation, Rural Telephone Finance Cooperative, CoBank, and the St. Paul Bank for Cooperatives—and reviewed documents they provided that describe their organizations and lending activities, and, as of June 30, 1997, the extent of their outstanding loans and the quality of their loan portfolios. We did not verify the accuracy of the loan information that they provided to us, but we noted that it was consistent with data in their 1996 annual reports, which had been audited by independent auditors. We also reviewed the reporting requirements of federal banking regulators to determine if commercial banks report on their lending activities for rural electricity and telecommunications purposes. However, the regulators do not require banks to report such information.

Much of the financial data presented in this report were taken from RUS' reports and automated records, which include data submitted by borrowers. We did not verify the accuracy of the information contained in the agency's reports and automated records. We also did not verify the accuracy of the submissions from the borrowers to RUS.

We conducted our review from May 1997 through December 1997 in accordance with generally accepted government auditing standards. We provided copies of a draft of this report to USDA for review and comment. The Department's comments and our response to them appear in appendix III and are discussed in the body of the report. We also provided extracts from our draft report to the Cooperative Finance Corporation and the Rural Telephone Finance Cooperative, and to CoBank and the St. Paul Bank, which covered their respective lending activity. We made technical corrections to the report on the basis of their comments.

# Major Contributors to This Report

| | |
|---|---|
| Food and Agriculture Issues—Kansas City Field Office | Ronald E. Maxon, Jr., Assistant Director<br>Ruth Anne Decker<br>Jerry D. Hall<br>Larry D. Van Sickle |
| Food and Agriculture Issues—Resources, Community, and Economic Development Division, Washington, D.C. | Patrick J. Sweeney |
| Office of the General Counsel, Washington, D.C. | Oliver H. Easterwood |

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**Postage & Fees Paid**
**GAO**
**Permit No. G100**

**Official Business**
**Penalty for Private Use $300**

**Address Correction Requested**