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RURAL UTILITIES SERVICE

Risk Assessment for the Electric Loan Portfolio

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to summarize the results of our work analyzing the Rural Utilities Service's (RUS) electric loan portfolio and the potential for future losses to the federal government from these loans. My testimony is based on our September 1997 report[1] on federal electricity activities, which discusses these issues in depth. Although the RUS portfolio contains electricity, telecommunications, and water and waste disposal loans, you asked that our testimony focus on electricity loans since they generally pose the greatest risk of loss to the federal government, particularly given the onset of competition in the electricity industry.

Deregulation of the electricity industry has led to wholesale competition, which, combined with other factors, has caused wholesale electricity prices to fall in many parts of the country. The increasingly competitive wholesale market and the financial vulnerability of the RUS borrowers have increased the risk of future losses the federal government faces. Thus, my testimony today will focus on the RUS electric loan portfolio and will discuss the findings from our September 1997 report concerning

- substantial write-offs of loans to rural electric cooperatives;
- likely additional losses to the federal government from loans to financially stressed[2] borrowers; and
- the potential for future losses from viable loans that may become stressed in the future due to high production costs and competitive or regulatory pressures.

I would like to begin my testimony by providing a brief background on the history and purpose of RUS. I will then discuss our risk assessment of the electric loan portfolio. Our assessment was generally based on the condition of the portfolio as of September 30, 1996; therefore, changes may have occurred since the date of our review.

Background

The U.S. Department of Agriculture (USDA) is the federal government's principal provider of loans used to assist the nation's rural areas in

[1]Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses (GAO/AIMD-97-110 and 110A, September 19, 1997).

[2]Borrowers classified by RUS as financially stressed have defaulted on their loans, had their loans restructured but are still experiencing financial difficulty, declared bankruptcy, or have formally requested financial assistance from RUS.

developing their utility infrastructure. Through RUS, USDA finances the construction, improvement, and repair of electrical, telecommunications, and water and waste disposal systems. RUS provides credit assistance through direct loans and through repayment guarantees on loans made by other lenders. Established by the Federal Crop Insurance Reform and the Department of Agriculture Reorganization Act of 1994, RUS administers the electricity and telecommunications programs that were operated by the former Rural Electrification Administration[3] and the water and waste disposal programs that were operated by the former Rural Development Administration. As of September 30, 1996, which was the most recent information available to us at the time of our review, RUS' entire portfolio of loans—including direct and guaranteed electricity, telecommunications, and water and waste disposal loans—totaled $42.5 billion.[4] Electricity loans made up over $32 billion, or 75 percent of this total.

Most of the RUS electric loans and loan guarantees were made during the late 1970s and early 1980s. For example, from fiscal years 1979 through 1983, RUS approved loans and loan guarantees of about $29 billion, whereas during fiscal years 1992 through 1996, it approved a total of about $4 billion in electric loans and loan guarantees. RUS electricity loans were made primarily to rural electric cooperatives; more than 99 percent of the borrowers with electricity loans are nonprofit cooperatives. These cooperatives are either Generation and Transmission (G&T) cooperatives or distribution cooperatives. A G&T cooperative is a nonprofit rural electric system whose chief function is to produce and sell electric power on a wholesale basis to its owners, who consist of distribution cooperatives and other G&T cooperatives. A distribution cooperative sells the electricity it buys from a G&T cooperative to its owners, the retail customers.

As of September 30, 1996, the bulk of the electric loan portfolio was made up of loans to the G&Ts. The principal outstanding on these G&T loans was approximately $22.5 billion, about 70 percent of the portfolio. Distribution borrowers made up the remaining 30 percent of the electric portfolio. At the time of our review, there were 55 G&T borrowers and 782 distribution borrowers. Our review focused on the G&T loans since they make up the majority, in terms of dollars, of the portfolio and generally pose the greatest risk of loss to the federal government.

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

[4]For a further discussion of the financial condition of the entire RUS portfolio, as of September 30, 1996, see our report Rural Development: Financial Condition of the Rural Utilities Service's Loan Portfolio (GAO/RCED-97-82, April 11, 1997).

The federal government incurs financial losses when borrowers are unable to repay the balances owed on their loans and the government does not have sufficient legal recourse against the borrowers to recover the full loan amounts. In all instances, G&T loans are collateralized; however, RUS has never foreclosed on a loan. RUS generally has been unable to successfully pursue foreclosure once the borrower files for bankruptcy because the borrower's assets are protected until the proceedings are settled. In addition, in recent cases where debt was written off, the government forgave the debt and therefore did not attempt to pursue further collection.

Substantial Loan Write-Offs Occurred in Recent Years

Under Department of Justice (DOJ) authority, during fiscal year 1996 and through July 31, 1997, RUS wrote off about $1.5 billion of loans to rural electric cooperatives. The most significant write-offs relate to two G&T loans. In fiscal year 1996, one G&T made a lump sum payment of $237 million to RUS in exchange for RUS writing off and forgiving the remaining $982 million of its RUS loan balance. The G&T's financial problems began with its involvement as a minority-share owner in a nuclear project that experienced lengthy delays in construction as well as severe cost escalation. When construction of the plant began in 1976, its total cost was projected to be $430 million. However, according to the Congressional Research Service, the actual cost at completion in 1987 was $3.9 billion as measured in nominal terms (1987 dollars). These cost increases are due in part to changes in Nuclear Regulatory Commission health and safety regulations after the Three Mile Island accident. The remaining portion is generally due to inflation over time and capitalization of interest during the delays. The borrower defaulted in 1986, had its debt restructured in 1993, and finally had its debt partially forgiven in September 1996. This borrower is no longer in the RUS program.

In the early part of fiscal year 1997, another G&T borrower made a lump sum payment of approximately $238.5 million in exchange for forgiveness of its remaining $502 million loan balance. The G&T and its six distribution cooperatives borrowed the $238.5 million from a private lender, the National Rural Utilities Cooperative Finance Corporation. The G&T had originally borrowed from RUS to build a two-unit coal-fired generating plant and to finance a coal mine that would supply fuel for the generating plant. The plant was built in anticipation of industrial development from the emerging shale oil industry. However, the growth in demand did not materialize, and there was no market for the power. Although the borrower had its debt restructured in 1989, it still experienced financial difficulties due to a depressed power market. RUS and DOJ decided that the best way to resolve the matter was to accept a partial lump sum payment on the debt rather than force the borrower into bankruptcy. The borrower and its member distribution cooperatives are no longer in the RUS program.

Additional Losses From Financially Stressed G&T Loans Are Probable in the Short Term

It is probable that RUS will have additional loan write-offs and therefore that the federal government will incur further losses in the short term from loans to borrowers that have been identified as financially stressed by RUS management. At the time of our review, RUS reports indicated that about $10.5 billion of the $22.5 billion in G&T debt was owed by 13 financially stressed G&T borrowers.[5] Of these, four borrowers with about $7 billion in outstanding debt were in bankruptcy. The remaining nine borrowers had investments in uneconomical generating plants and/or had formally requested financial assistance in the form of debt forgiveness from RUS. According to RUS officials, these plant investments became uneconomical because of cost overruns, continuing changes in regulations, and soaring interest rates. These investments resulted in high levels of debt and debt-servicing requirements, making power produced from these plants expensive. (See attachment I for a list and brief discussion of these borrowers.)

Since cooperatives are nonprofit organizations, there is little or no profit built into their rate structure, which helps keep electric rates as low as possible. However, the lack of retained profit generally means the cooperatives have little or no cash reserves to draw upon. Thus, when cash flow is insufficient to service debt, cooperatives must raise electricity rates and/or cut other costs enough to service debt obligations. If they are unable to do so, they may default on their government loans.

This was the scenario for the previously discussed write-offs in fiscal year 1996 and through July 31, 1997. Additional write-offs are expected to occur. For example, according to RUS officials, at the time of our review, the agency was considering writing off as much as $3 billion of the total $4.2 billion debt owed by Cajun Electric, a RUS borrower that has been in bankruptcy since December 1994. Cajun Electric filed for bankruptcy protection after the Louisiana Public Service Commission disapproved a

[5]In our previous report, Rural Development: Financial Condition of the Rural Utilities Service's Loan Portfolio (GAO/RCED-97-82, April 11, 1997), we noted 12 G&T and distribution borrowers that were delinquent or in financial distress. However, in this testimony, as in our September 1997 report, we discuss 13 financially stressed G&T borrowers identified by RUS management. The primary difference is that this testimony and our September 1997 report do not include one financially stressed distribution borrower, but did include two borrowers that have officially requested financial assistance.

requested rate increase and instead lowered rates to a level that reduced the amount of revenues available to Cajun to make annual debt service payments. Several factors contributed to Cajun's heavy debt, including its investment in a nuclear facility that experienced construction cost overruns and its excess electricity generation capacity resulting from overestimation of the demand for electricity in Louisiana during the 1980s.

Some Losses From Loans Considered Viable Are Probable in the Future

In addition to the financially stressed loans, RUS had loans outstanding to G&T borrowers that were considered viable by RUS but may become stressed in the future due to high costs and competitive or regulatory pressures. We believe it is probable that the federal government will eventually incur losses on some of these G&T loans.

We believe the future viability of these G&T borrowers will be determined based on their ability to be competitive in a deregulated market. In order to assess the ability of RUS cooperatives to withstand competitive pressures, we focused on production costs[6] for 33 of the 55 G&T borrowers with loans outstanding of about $11.7 billion as of September 30, 1996. We excluded 9 G&Ts that only transmit electricity and the 13 financially stressed borrowers discussed above. Our analysis showed that for 27 of the 33 G&T borrowers, production costs were higher in their respective regional markets than investor-owned utilities, and that for 17 of the 33, production costs were higher than publicly-owned generating utilities. The relatively high average production costs indicate that the majority of G&Ts may have difficulty competing in a deregulated market. RUS officials told us that several borrowers have already asked RUS to renegotiate or write off their debt because they do not expect to be competitive due to high costs. RUS officials stated that they will not write off debt solely to make borrowers more competitive.

As with the financially stressed borrowers, some of the G&T borrowers considered viable by RUS at the time of our work had high debt costs because of investments in uneconomical plants. In addition, according to RUS officials, there are two unique factors that cause cost disparity between the G&Ts and their competition. One factor is the sparser customer density per mile for cooperatives and the corresponding high cost of providing service to the rural areas. A second factor has been the inability to refinance higher cost Federal Financing Bank (FFB) debt when lower interest rates have prevailed. However, RUS officials said that recent

[6]As a surrogate for production costs, w\ used average revenue per kilowatthour (kWh) for wholesale sales (sales for resale), which is explained in detail in our September 1997 report.

legislative changes that enable cooperatives to refinance FFB debt with a penalty may help align G&T interest rates with those of the investor-owned utilities.

In the short term, G&Ts will likely be shielded from competition because of the all-requirements wholesale power contracts between the G&T and their member distribution cooperatives. With rare exceptions, these long-term contracts obligate the distribution cooperatives to purchase all of their respective power needs from the G&T. In fact, RUS requires the terms of the contracts to be at least as long as the G&T loan repayment period. However, wholesale power contracts have been challenged recently in the courts by several distribution cooperatives because of the obligation to purchase expensive G&T power. According to RUS officials, one bankrupt G&T's member cooperatives challenged their wholesale power contracts in court in order to obtain less expensive power. RUS officials believe that the long-term contracts will come under increased scrutiny and potential renegotiation or court challenges as other sources of less expensive power become available.

Wholesale rates under these contracts are set by a G&T's board of directors with approval from RUS. In states whose commissions regulate cooperatives, the cooperatives must file requests with the commissions for rate increases or decreases. Several of the currently bankrupt borrowers were denied requests for rate increases from state commissions. However, RUS officials indicated they do not expect G&Ts to pursue rate increases as a means to recover their costs because of the recognition of declining rates in a competitive environment. RUS officials also acknowledge that borrowers with high costs are likely to request debt forgiveness as a means to reduce costs in order to be competitive in the future.

As discussed above, denials of requested rate increases by state commissions culminated in several G&Ts filing for bankruptcy. Eighteen of the RUS G&T borrowers operate in states where regulatory commissions must approve rate increases. These commissions may deny a request for a rate increase if they believe such an increase will have a negative impact on the region. According to RUS officials, some commissions have denied rate increases to cover the costs of projects that the commissions had previously approved for construction. Therefore, G&Ts with high costs may be likely candidates to default on their RUS loans, even without direct competitive pressures.

In summary, in the last several years, through July 1997, RUS has experienced loan write-offs of $1.5 billion. Additional write-offs related to the $10.5 billion in loans identified by RUS as financially stressed as of the time of our review are likely in the near term. And finally, RUS has loans outstanding to G&T borrowers that are currently considered viable by RUS that may become stressed in the future due to high production costs and competitive or regulatory pressures. We believe it is probable that the federal government will incur losses eventually on some of these G&T loans. The future viability of these G&T loans will be determined based in part on the RUS cooperatives' ability to be competitive in a deregulated market.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions you or other Members of the Subcommittee may have.

Information on the 13 Financially Stressed G&T Borrowers as of September 30, 1996

The following is a list and brief discussion of each of the 13 financially stressed G&T borrowers. This information is as of September 30, 1996; therefore, changes may have occurred subsequent to our review.

Table I.1: RUS Financially Stressed G&T Cooperatives, as of September 30, 1996

Dollars in millions

Borrower	Total debt outstanding
Borrower A[a,b]	$1,619.6
Borrower B	167.9
Borrower C	103.2
Borrower D[b]	562.3
Borrower E[b]	183.3
Borrower F[a,b]	1,101.2
Borrower G[a,b]	4,154.8
Borrower H[b]	313.4
Borrower I[b]	354.8
Borrower J	1,070.7
Borrower K	445.1
Borrower L	351.7
Borrower M[a]	92.8
Total debt	**$10,520.8**

[a]Cooperative in bankruptcy.

[b]State regulated cooperative.

Borrower A: Invested in construction of a nuclear plant that experienced cost overruns and was never completed. The state commission denied rate increases to cover the cost of the cooperative's investment in the plant. The borrower defaulted on its loan in 1984 and declared bankruptcy in 1985. The bankruptcy proceedings have been in court for 12 years and are still not completely resolved.

Borrower B: Made an investment in a nuclear plant that proved to be uneconomical. While this borrower does not appear to be currently experiencing financial difficulties, RUS considers it financially stressed because it has formally requested financial assistance due to impending competitive pressures.

Borrower C: Made an investment in a nuclear plant that proved to be uneconomical. While this borrower does not appear to be currently experiencing financial difficulties, RUS considers it financially stressed because it has formally requested financial assistance due to impending competitive pressures.

Borrower D: Uses primarily coal-fired generation. The borrower overbuilt due to anticipated growth in electricity demand that did not occur. During construction of a new plant, economic conditions in the area changed and demand for electricity dropped, which resulted in less revenue than predicted from the plant. The cooperative was repeatedly denied rate increases to cover the cost of its plants by the state commission.

Borrower E: Has a small percentage share in a nuclear plant that proved to be uneconomical. The borrower has substantially higher electricity rates than the investor-owned utilities in its region. The cooperative has been denied rate increases to cover its losses by the state commission. Although the borrower has had some of its debt refinanced, it is still experiencing financial difficulties.

Borrower F: A G&T with primarily coal-fired generating plants that overbuilt due to anticipated industrial growth related to two large aluminum smelting companies. When aluminum prices dropped in the early 1980s, the companies threatened to move their operations if the cooperative did not lower electricity rates. The state commission denied rate increases over the fear of losing these industries. RUS restructured the borrower's debt in 1987 and 1990. The cooperative filed for bankruptcy in September 1996 because its other creditors were unwilling to negotiate.

Borrower G: Built a coal-fired plant and invested in a nuclear plant in the mid-1970s that was completed late and experienced construction cost overruns. Several factors contributed to the cooperative's heavy debt, including excess electricity generation construction resulting from overestimation of the demand for electricity during the 1980s. The new capacity was intended to serve a growth in demand that did not materialize. The state commission disapproved a rate increase and instead lowered rates to a level that precluded full debt service coverage. The commission also refused to support a restructuring agreement that included a significant RUS loan write-off.[1] The rate increase was requested by the cooperative because of its high costs. The borrower filed for bankruptcy in December 1994.

[1]In states that regulate cooperatives, the state commissions must approve restructuring agreements between the cooperatives and their creditors.

Borrower H: Invested in construction of a nuclear plant that proved to be uneconomical. The project was completed 10 years late and over budget. In addition, there was a dramatic drop in the demand for electricity in the cooperative's service area, and the state commission would not allow rate increases to recover capital investment. The borrower had its debt restructured in 1987; however, it is requesting additional financial assistance due to anticipated competitive pressure. A final settlement between RUS and the borrower was reached in June 1997. The borrower was expected to receive a write-off of $165 million. The final payment and related debt write-off were scheduled to occur December 30, 1997.

Borrower I: Invested in a clean-burning coal plant that experienced severe cost overruns. The borrower has substantially higher electricity rates than the investor-owned utilities in its region. The state commission has denied the cooperative's request for rate increases. The borrower had some of its debt refinanced, but it is still experiencing financial difficulty.

Borrower J: Invested in a nuclear plant that proved to be uneconomical. The plant was completed late, which resulted in cost overruns. As a result, the cooperative's wholesale power rates are very high. The borrower has requested debt restructuring due to its high cost of production and anticipated competitive pressure.

Borrower K: Invested in a nuclear plant that proved to be uneconomical. The plant was completed late, which resulted in severe cost overruns. The cooperative's wholesale power rates are very high, which has resulted in extreme unrest in the member distribution cooperatives. The borrower is surrounded by investor-owned utilities with lower wholesale rates. In addition, the borrower's system is very difficult and expensive to maintain and experiences frequent power outages. The borrower has requested financial assistance because of anticipated competitive pressure.

Borrower L: Invested in a nuclear plant that proved to be uneconomical. The plant was completed late, which resulted in severe cost overruns. The cooperative has only five member distribution cooperatives, which makes it difficult to cover its high production costs. This borrower chose not to declare bankruptcy and is seeking financial assistance. This borrower has refinanced its debt to lower its interest rate, but is still experiencing financial difficulty and has requested additional financial assistance.

Borrower M: Invested in a nuclear plant that proved to be uneconomical. In addition, the cooperative had a stagnant customer base in the 1980s. RUS tried to negotiate a restructuring agreement, but the state commission denied two separate plans. In April 1996, the borrower filed for bankruptcy.

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