COMPETITION BETWEEN SMALL BUSINESS

AND

RURAL ELECTRIC AND TELEPHONE COOPERATIVES

IN NON-UTILITY BUSINESS

Final Report
to
The Small Business Administration
in compliance with
Contract No. SBA-2099-AER-87

by

SVL Associates
23046 Avenida De La Carlota, Suite 650
Laguna Hills, California 92653
(714) 855-9082

May, 1989

LAGUNA HILLS, CALIFORNIA
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DISCLAIMER

This study is based on work supported by SBA contract number SBA-2099-AER-87. Statements and conclusions herein are the contractor's and not the views of the U.S. Government or the Small Business Administration.
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I. EXECUTIVE SUMMARY
EXECUTIVE SUMMARY

A new and growing problem for many small businesses is competition with rural electric and telephone cooperatives (RECs and RTCs) in non-utility areas such as natural gas marketing & sales, satellite dishes & equipment, cable TV, appliance sales & services, customer premises equipment, 2-way radio, telephone business systems, cellular phones, computer equipment, and heating & air conditioning services. The potential cross-subsidies between utility and non-utility operations have raised many questions concerning utility diversification, subsidization of non-utility business by utility ratepayers, cost allocation, asset valuation and pricing, financial controls, the Rural Electrification Administration's regulations and policies, and its funding of the cooperatives. Currently, very little data exists about the nature of these problems, attempts at resolving the problems, and the applicable state, federal, and regulatory mechanisms to address the problems.

This study examines the potential unfair competition issues relating to RECs and RTCs diversified into non-utility businesses. The diversification of cooperatives into non-utility businesses has potential impact on either or both of two groups: ratepayers and small business competitors. It is also clear that such activities will necessarily impact the responsibilities of regulatory agencies and thereby increase the cost of regulation.

RECs and RTCs are unique public utilities since they can obtain low-cost financing from the Rural Electrification Administration (REA), the National Rural Utilities Cooperative Finance Corporation (CFC) and others. These cooperatives also enjoy special tax treatment which, for many of them, results in tax exempt status. If significant cross-subsidies between these cooperatives' traditional utility and other business ventures were found, small businesses would clearly be at a disadvantage in competing with cooperatives since most small businesses have difficulty obtaining financing and must face a high cost of capital, and do not have the advantages that a utility can bring to the competitive sector of the economy such as credit ratings, operations, marketing and financing. In addition, cross-subsidization will cause utility ratepayers to subsidize diversification activities and eliminate from the competitive market even efficient, well-managed competitors.

Surveys of small business trade associations, state and federal regulators, and the rural utility cooperatives themselves were conducted by SVL Associates (SVL) in order to study and describe the scope and nature of these problems. The diversification activities of cooperatives and the related competitive concerns, if any, are described. Applicable laws, regulations, and policies, at both the state and federal level, are
reviewed and commented on. Case studies are presented to illustrate the problems, attempts to resolve the problems, and their ultimate resolution. Finally, recommendations for policy options, as appropriate, are offered.

The argument between small businesses and cooperatives in the areas of selling appliances, cost allocation, cost of service analysis and cost based pricing policy have recently been brought to the attention of the supreme courts of the states of South Carolina and Georgia. The promotional practices of cooperatives such as offering rebates and free appliances to induce fuel switching have been brought to the attention of the Georgia Public Service Commission.

Overall, the results of our research suggest that cross-subsidization and unfair competition may indeed exist due to inadequate regulation of cooperatives across the country. Our surveys suggest that many cooperatives and their diversified business ventures are not subject to any regulation. Where regulation does take place, the diversification phenomenon has encountered state and federal regulatory commission responses that differ in approach but have as a common theme and primary goal the protection of the public interest. Very few commissions have, however, thoroughly considered the overall policy issues associated with diversification to strategically plan for consistent and effective regulation. State regulation of diversification and affiliated interests is commonly an ad hoc event undertaken on a case-by-case basis. REA audits loan funds advanced and disbursed by REA borrowers and also requires a CPA audit. However, the audits do not reveal information to detect cross-subsidization. Therefore, illegal cross-subsidization of cooperatives within the states which do not regulate cooperative rates may never be discovered by any regulatory agencies.

A particular problem for the small business competitors of a cooperative's non-utility venture engaged in some manner of unfair competition is that of pursuing charges. There is not only the difficulty of identifying which regulatory body, if any, has authority over the cooperatives in a given state, but also the problem of the costs to be faced. Many commissions will not undertake their own investigations but, rather, require the complainant to provide detailed evidence of the alleged abuse.

This study provides the basis for the following recommendations:

1. Under the current federal budget constraint and the potential unfair competitive advantage of cooperatives against non-subsidized, tax paying small businesses, Congress may consider reforming the Rural Electrification Administration's loan program and evaluate alternative tax treatments for rural
electric and telephone cooperatives as recommended by the United States General Accounting Office.

2. The state public utility commissions should be granted the authority to regulate all rural electric/telephone cooperatives operating within their jurisdiction in the same fashion as they regulate investor-owned utilities. The state public utility commissions would create an effective forum to raise cross-subsidization and unfair competition issues.

3. The Rural Electrification Administration and state public utility commissions should require all cooperative borrowers with non-utility businesses to perform a detailed annual cost of service/cost allocation study to avoid cross-subsidization between utility and non-utility operations.

4. The Federal Trade Commission, the Rural Electrification Administration and state regulators should take a closer look at the diversification of cooperatives into non-utility businesses so that a national policy toward preventing cross-subsidization and unfair methods of competition can be developed.

Until changes are made in the regulation of cooperatives, it would appear that the best strategy for small businesses is to form associations which can use financial resources and assets provided by a large membership to bring those cases of unfair competition to the level of national attention which offer the possibility of setting new regulatory precedents.
II. INTRODUCTION
INTRODUCTION

Rural electric/telephone cooperatives (RECs/RTCs) across the country have, in recent years, entered into a wide range of diversified business ventures related as well as unrelated to their traditional electric/telephone utility services. For various reasons, cooperatives are diversifying into a number of different areas such as natural gas marketing & sales, satellite TV programming, satellite dishes & equipment, cable TV, appliance sales and services, customer premises equipment, Radio Shack, 2-way radio, telephone business systems, computer stores, and cellular phones. Some of these products and services have historically been provided almost exclusively by small business enterprises. Diversification brings RECs/RTCs into competition with independent businesses already operating in the field. There are many arguments both for and against such diversification.

RECs/RTCs cited many reasons for pursuing diversification. These include rural economic development, improving the economic condition of rural communities, making use of management skills, attracting better managerial talent and for electric utilities, managing load to maximize return on generating capacity and avoiding expenditures for development of additional capacity. They are in effect lowering the costs of energy and providing benefit to ratepayers. Many small business operators strongly disagree, and argue that the threats to small business posed by unfair cooperative competition substantially outweigh the economic benefits. The basic complaint registered by small business is that RECs/RTCs enjoy considerable advantages over small business competitors such as financing, marketing, operations and tax treatment. The entry of RECs/RTCs into diversified ventures, which historically have been provided by small business, competes directly with small business for clients, creating conditions where private businesses are simply unable to compete. RECs/RTCs may be able to undercut prices not because they provide superior products or services, but because cooperatives have fundamental advantages in financing, marketing, operations, tax treatment and cross-subsidization i.e. using their utility assets to subsidize other diversified activities. In addition, most states do not regulate the rates or diversification activities of cooperatives. Therefore, it is difficult to detect any unfair competition or cross-subsidization.

The focus of this report is the competition between small business and the RECs/RTCs engaged in non-utility businesses. This subject involves complex legal and factual matters, including that of the role of the Rural Electrification Administration's regulations and policies, and its funding of these cooperatives. A central concern is the potential for cross-subsidies between the cooperative's utility and non-utility operations. The purpose of the report is to (1) examine the scope and degree of the problem
caused by REC/RTC diversification, (2) review actual cases, (3) review applicable laws and regulations, and (4) make recommendations for policy options, as appropriate.

This study is presented in three sections. The first details the growth, financing and regulation of RECs/RTCs. The next section relates to the potential unfair competition between these cooperatives and their small business competitors. This section contains a detailed discussion of the issues involved, followed by several case studies which illustrate some of the problems, the attempts to resolve these problems, and their ultimate resolution. The final section offers a brief discussion of recommendations based on our findings. There are separate bibliographies, relevant to the specific topic, offered in several subsections of the report.
III. THE GROWTH, FINANCING AND REGULATION OF RECs/RTCs
III. A. THE HISTORY OF RECs/RTCs
THE HISTORY OF RECs/RTCs

Rural electric and telephone cooperatives (RECs/RTCs) are consumer-owned organizations whose original purpose was to supply electric and telephone service to the people of rural America. Prior to World War II, people residing in the rural areas of the U.S. generally had few of the technological comforts and conveniences that their urban counterparts had begun to take for granted. For example, the U.S. Department of Agriculture (USDA) estimated that only one out of ten farms in the U.S. had electric services. Furthermore, it was estimated that rural families without electricity spent over ten hours per week pumping water and carrying it from source to kitchen.

There is no exact answer to the question of when the first electric cooperative was formed in the United States, but some chroniclers agree that prior to World War I a few existed. The Stoney Run Light and Power Company at Granite Falls, Minnesota, was established in 1914, and the Kegonsa Electric Company, at Stoughton, Wisconsin, was formed in 1916. After World War I, cooperatives increased as the need and demand for service increased.

The creation of a cooperative usually began with the farmers in a certain area getting together and talking over the situation. They would then call a community meeting, sign up for electrical service, and pay a small membership fee. These local groups were dissatisfied with private utility companies which felt that providing service to the rural areas of the U.S. would be an unprofitable endeavor. Therefore, these farmers would organize themselves for the purpose of borrowing funds for line-building.

Once the lines were built, a decision had to be made as to who would operate and maintain them. While some groups chose to turn the lines over to the local power company, others remained independent of power companies and became known as cooperatives. Although the establishment of cooperatives began to solve the problem of rural electrification, there was still concern about the high failure rate. Many electric cooperatives were spontaneously organized without legal counsel, with little technical advice on construction, with little managerial direction and most importantly, with inadequate financing. Furthermore, cooperative associations also suffered from attacks by electric companies with low pricing strategies. In summary, except for success in some local areas, progress toward rural electrification was slow.

The process of encouraging outside interest in the farmers' plight was a long one. In 1911, Progressive Power Company executives of the then 30-year old electric industry had become conscious of the potential farm market. But the entire resources of the industry were absorbed in supplying power to manufacturers during World War I and the industrialization. As demand for
electricity for farm areas grew steadily after 1918, pressure coming from organized farm groups and from congressmen from rural states grew more insistent.

In March 1923, the National Electric Light Association (NELA), the forerunner of the Edison Electric Institute, organized the Committee on the Relation of Electricity to Agriculture (CREA). The committee was formed as a direct result of a meeting of the NELA with the Overhead Systems Committee which reported the negative attitudes of utility company managers toward rural electrification. The NELA also wanted a group to represent the farmers' views. With this in mind, the NELA formed the CREA with assistance from the American Farm Bureau Federation (AFBF) to promote coordination of the power industry and agriculture. CREA brought together farm groups, government bureaus, and equipment manufacturers to study the potential uses of electricity on the farm and to determine whether a profitable farm market could be built up. Although the public was represented in the CREA, the committee was oriented toward private enterprise. Individual power companies and appliance manufacturers provided funds for the program.

Around the same time, across the country, state committees were formed to study the relationship of electricity to agriculture. Many reports that came out of the work of the CREA showed that rural electrification was practical. Utility companies, however, failed to act due to the fact that they perceived the farm market to be limited and scattered, and thought it would be very costly to build rural power lines. From a farmer's perspective, the charges for electricity would be too high to afford.

By 1930, CREA was regarded as a failure due to the low penetration rate. Only 9.5 percent of farms in the United States had electricity with central station service. CREA finally dissolved itself in 1939. During its short life span, however, more than 200 uses of electricity were developed and improved through its sponsorship. There were also a limited number of successful electric cooperatives organized by farmers when CREA was in operation.

In 1933, the appearance of a liberal national administration partly dependent upon farm support provided an opportunity for action on the rural electrification issue. The first official expression of interest appeared in two studies on the conservation and planned use of natural resources. In October 1934, the Mississippi Valley Committee of the Public Works Administration Report suggested an allotment of $100,000,000 to build independent, self-liquidating rural electric projects and active leadership from federal government.

The recovery program instituted in 1935 provided the immediate justification for federal sponsorship of rural electrification. It was believed that a program of federally financed projects would
put the jobless to work, provide employment in related industries, and stimulate spending. With this objective, the Emergency Relief Appropriation Act of 1935 made available an amount not exceeding $100,000,000 for rural electrification projects.

In May 1935, President Franklin D. Roosevelt, by Executive Order No. 7037, created the Rural Electrification Administration (REA) as an independent agency to promote rural electrification.

Initially, regulation required that at least 25 percent of the funds be spent for labor and 90 percent of the labor be secured from relief rolls. Executive Order No. 7130, issued August 7, 1935, freed REA from the relief requirements and made it basically a lending agency. This order assumed that any borrower capable of constructing and operating a rural electrical distribution system, and legally competent, would be eligible for a loan.

The Rural Electrification Administration was made permanent by Congress with the passage of the Norris-Rayburn bill on May 20, 1936. The act that made REA an agency of the Department of Agriculture was officially deemed the "Rural Electrification Act of 1936" (the Act).

The Act directs that the powers of REA be exercised by an Administrator, who will be under the general direction and supervision of the Secretary of Agriculture. The REA Administrator is authorized to make rural electrification and telephone loans and to investigate and publicize the condition and progress of rural electrification and telephone service. REA loans can be made by the Administrator for rural electrification to eligible borrowers at the rate of 2 percent (now 5 percent) per year, with a maximum amortization period of 35 years. An eligible borrower would be defined as a person, corporation, state, territory, subdivision, municipality, or cooperative, nonprofit, or limited-divided association organized under the laws of any state or territory of the United States, for the purpose of financing the construction and operation of generating plants, electric transmission and distribution lines or systems for the furnishing of electric energy to persons in rural areas who are not receiving central station service.

The Act authorizes the Secretary of the Treasury to provide the funds that will be used for REA electrification and telephone loans. The Act also provides a state allotment formula for the distribution of electrification loan funds. Likewise, the Act authorizes the appropriation of funds for the purpose of making the studies, investigations, publications, and reports that are necessary to execute the electrification and telephone loan programs.

Section 5 of the Act gives the Administrator power to make loans for the purpose of financing the wiring of the premises in
rural areas as well as the acquisition and installation of electrical and plumbing appliances and equipment. However, REA has not extended a loan under section 5 since 1972.

The Act also provides guidelines that relate to the acquisition and disposition by the REA Administrator of property used to secure loans and prohibits disposition of property acquired by borrowers with REA loan funds, unless the Administrator approves, until the loan is fully repaid. Additionally, the Act gives the Administrator the power to stipulate that certain loans and contracts that were entered into prior to the effective date of the Act (May 20, 1936) are still covered under the Act.

According to the Act, the Administrator is also given the authority to appoint officers and employees at a certain compensation level as well as to utilize the voluntary services of Federal, State, and local employees as are available. However, the selection of employees and appointment of officials must be made solely on the basis of merit and efficiency. If the President of the United States uncovers any violation in this area, he is allowed to remove the Administrator from his position as well as any employee or official who is chosen on a partisan basis.

The Administrator is also required under the Act to present a full report of his activities to Congress by April 20 of each year. Furthermore, the Act authorizes the Administrator to extend the time of payment of interest or principal of loans with certain limitations.

Finally, as used in the Act, the term "rural area" shall be regarded as any area of the United States not included within the boundaries of any city, village, or borough having a population in excess of 1,500 people. Also, the term "farm" shall be deemed to mean a farm as defined in the publications of the Bureau of the Census.
BIBLIOGRAPHY


III. B. THE EXPANSION OF RECs/RTCs (1935-1986)
THE EXPANSION OF RECs/RTCs (1935-1986)

By 1935, at least 30 cooperatives had started distributing electricity in previously unserved rural areas. These cooperatives, however, were able to service only about 11 percent of U.S. farms. When the Rural Electrification Administration (REA) was established in 1935, however, to provide low-interest loans to farmers, the process of rural electrification progressed significantly. Presently, approximately 99 percent of all dwelling units, both farm and nonfarm, receive electric service.

The existence of the REA expanded the number of rural electric cooperatives almost immediately. As of October 31, 1941, 721 of 760 (94.9%), REA financed operating systems were cooperatives or public power districts functioning similarly, and 98.2 percent of the REA allotted fund had gone to cooperatives. While many RECs were brought into existence by the REA, all have been guided and supervised by it. Most electric cooperatives have now passed through the early stages of promotion, organization, and initial construction. As Charles Gill, the CFC Governor, said in the 1987 District Meetings:

"In the first 20 years of our program, we were all alike. . . . After the mid 60's or so, we started to rapidly develop different characteristics. We began to develop into the outer urban, then suburban areas. We had those who wanted to be debt free and those who didn't. We had the public power-supplied systems and those who were privately or self-supplied. These changes produced a widely disparate group of systems that each year have less and less in common other than having REA as a source of funding."

The customer profile of REA-borrowers was one of the major factors that contributed to the change. For instance, prior to World War II, over 80 percent of the customers of REA-borrowers lived on farms. However, both the number of farms and the total farm population have declined significantly since 1936. For example, while there were 6,640,000 farms in the U.S. in 1936, there were only 3,704,000 in 1959, a decline of approximately 44 percent.

During World War II, there was a steady increase in applications received by REA-borrowers for industrial and commercial power service. Many of these came from manufacturing and processing industries - especially from plants using rural and farm products. The postwar years brought an intensification of efforts to secure commercial and industrial users.

The 1960's and 1970's were a time of general prosperity for the electric industry since there was a migration of large numbers of people to what were once rural areas. The population phenomenon

III-6
of the 1970's was a situation where rural areas, for the first time in more than a century, had grown faster than metropolitan areas. There was a large expansion of REA loans that accompanied the industrial and residential growth in rural areas during this period.

Rural electric systems are the fastest growing segment of the electric utility industry. They serve about 10.9 percent of the population, sell about 7.2 percent of the kilowatt-hours and generate about 4.9 percent of the nation's electricity.

The rural electric market share has increased steadily since the mid-1930's, when the first REA loan was approved. However, the pace of this increase has slowed greatly during the 1980's. This slow-down is tied directly to the state of the rural economy and the slowing of rural population growth.

Rural electric systems serve more than 25 million consumers in 46 states. In 16 of these states, they serve more than 20 percent of the total population of the state. These states are concentrated in the South and the Upper Midwest. In 10 other states, rural electrics serve at least 10 percent of the population.

Rural electric systems sell about two-thirds of their power to residential consumers (farm and nonfarm). This differs greatly from investor-owned and municipal utilities, which sell about two-thirds of their energy to commercial and industrial consumers and only one-third to residential consumers.

As shown in Exhibit 1, the increase in consumers was strongest during the period of 1970-1979. The consumer growth rate was 2.6 percent in 1985 and 2.8 percent in 1984. The average rate during the 1970's was more than 4 percent. This slow-down in rural electric consumer growth mirrors the decline in non-metropolitan population growth during the 1980's.

Sales to residential consumers increased by 1.7 percent during 1984. Sales to commercial consumers grew by 5.7 percent, and sales to industrial consumers increased by 1.3 percent. Rural electric kWh sales grew by 2.4 percent during 1985, when the industry average was 1.9 percent. Much of the 2.4 percent growth came from a 5.7 percent increase in sales to commercial consumers. Sales to industrial consumers, who account for only 16 percent of rural electric sales, showed little movement, growing by a sluggish 1.3 percent.

The rural electric systems with the most rapid growth in kWh sales during the 80's were concentrated in the western and eastern portions of the U.S. Those with growth significantly below the 2.4 percent average were mainly in the Midwest. The depressed farm economy was the major cause.
As shown in Exhibit 2, 1985 was the first year in which rural electric systems generated more than half of the electricity they sold to their consumers. The rest came from purchases from power companies and public power sources.

During the last two decades, the percentage of total power needs supplied by public power sources has declined steadily. Because public power projects are mainly hydroelectric and sell power at cost, this change has greatly increased the wholesale power costs of rural electric systems.

As shown in Exhibit 3, at the end of 1985, rural electric systems owned 29.3 megawatts of generating capacity, more than triple the 1976 level of 9.7 MW. This remarkable increase in generating capacity was accomplished with the support of REA, and the objective was to insure adequate future supplies of power for rural electric consumers.

As shown in Exhibits 4 and 5, although rates have stabilized, more than 75 percent of the 1,000 rural electric systems have higher retail rates than their neighboring utility. This disparity is caused by the higher costs of serving rural areas and the fact that construction of new power plants has increased rural electric rates more than those of other utilities. Other utilities have a greater number of plants built at lower costs per megawatt. Many rural electric systems face severe rate disparity, a problem which shows no sign of being resolved. As of Jan. 1, 1985, 103 systems had rates that were more than 40 percent higher than their neighboring utility and 136 systems had rates 25 percent to 40 percent higher. By contrast only 11 systems had rates 40 percent lower and only 34 systems were 25 percent to 40 percent below their neighboring utility.

As shown in Exhibit 6, the cumulative rural electrification financing as of December 31, 1986, associated with REA loans was $19.41 billion. Other long-term loans to REA borrowers from non-REA sources were obtained mostly from the Federal Financing Bank.

In contrast to the rural electric loan program that originated in 1935, the REA rural telephone loan program was not established until October 28, 1949, when an amendment to the Rural Electrification Act authorized REA to make loans to improve and extend telephone service in rural areas.

In 1950, according to U.S. Census figures, only 38.2 percent of the farms in the United States had telephone service. A considerable portion of this service was inadequate and of low quality. Improvement and expansion programs were limited because the type of financial assistance required was not generally available to local telephone systems. Establishment of the REA telephone loan program provided a needed source of credit and gave
fresh hope to people in the rural areas for full telephone coverage with high quality service. An estimated 96 percent of the Nation's farms now have telephone service, all of which is automatic dial service.

Funds for the first telephone loan to the Florala Telephone Company of Florala, Alabama, were approved on February 24, 1950. The Fredericksburg and Wilderness Telephone Company of Chancellor, Virginia, placed the first REA-financed facilities in service in September 1950 and made the first repayment to the Government two years later.

On May 7, 1971, the Rural Electrification Act was amended to establish the Rural Telephone Bank (RTB). The RTB was established as a lending agency operating in conjunction with REA to provide supplemental financing for the REA telephone loan program.

As shown in Exhibit 7, as of December 31, 1986, REA and RTB had advanced approximately $4.37 billion and $1.56 billion respectively, in loans to RTCs.
EXHIBITS
EXHIBIT 1
% Increase in Consumers Since 1960

<table>
<thead>
<tr>
<th>Period</th>
<th>Annual Percentage</th>
</tr>
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<tbody>
<tr>
<td>1960-1969</td>
<td>2.65%</td>
</tr>
<tr>
<td>1970-1979</td>
<td>4.23%</td>
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<tr>
<td>1980-1985</td>
<td>2.88%</td>
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</tbody>
</table>

Source: Rural Electrification, Nov. 1988
EXHIBIT 2
Source of Power

Percentage
70% -
60% -
50% -
40% -
30% -
20% -
10% -
0% -

Rural Electric 50.4%
Public Power 46.1%
Investor-owned 35.6%

Source: Rural Electrification, Nov. 1986
EXHIBIT 3
Total Generating Capacity

Thousands of Megawatts

Source: Rural Electrification, Nov. 1986
EXHIBIT 4
Residential Bills at 1,000 kWh

Percent of Systems

<table>
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<tr>
<th>Year</th>
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<th>Rate &gt; Neigh. Util.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>47.8%</td>
<td>52.2%</td>
</tr>
<tr>
<td>1982</td>
<td>46.9%</td>
<td>53.1%</td>
</tr>
<tr>
<td>1983</td>
<td>31.5%</td>
<td>68.7%</td>
</tr>
<tr>
<td>1984</td>
<td>27.7%</td>
<td>72.3%</td>
</tr>
<tr>
<td>1985</td>
<td>24.2%</td>
<td>75.8%</td>
</tr>
</tbody>
</table>

Source: Rural Electrification, Nov. 1986
EXHIBIT 5
Res. Rate Compar. at 1,000 kWh, 1985

Number of Systems

<table>
<thead>
<tr>
<th>Percentage Range</th>
<th>Rate &gt; Neigh. Util</th>
<th>Rate &lt; Neigh. Util</th>
</tr>
</thead>
<tbody>
<tr>
<td>OVER 40%</td>
<td>103</td>
<td>11</td>
</tr>
<tr>
<td>25%-40%</td>
<td>136</td>
<td>34</td>
</tr>
<tr>
<td>15%-25%</td>
<td>168</td>
<td>39</td>
</tr>
<tr>
<td>0%-15%</td>
<td>288</td>
<td>138</td>
</tr>
</tbody>
</table>

Source: Rural Electrification, Nov. 1986
EXHIBIT 6

SUMMARY OF RURAL ELECTRIFICATION FINANCING
(Dollar Amounts in Thousands)

FINANCING APPROVED BY PURPOSE - CUMULATIVE TOTALS

<table>
<thead>
<tr>
<th>As of May 11, 1985 through Dec. 31, 1986</th>
<th>Financing Approved By Purpose - CUMULATIVE TOTALS</th>
</tr>
</thead>
<tbody>
<tr>
<td>REA Loans</td>
<td>with REA Guarantees</td>
</tr>
<tr>
<td>------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>May 11, 1985</td>
<td>15,834,615</td>
</tr>
<tr>
<td>Dec. 31, 1985</td>
<td>18,657,227</td>
</tr>
<tr>
<td>Dec. 31, 1986</td>
<td>18,568,611</td>
</tr>
<tr>
<td>Dec. 31, 1986</td>
<td>18,412,623</td>
</tr>
</tbody>
</table>

1. Includes Pollution Control Bond Funding, which may be rescinded at a later date.
2. Includes loans obtained by REA borrowers' affiliates specifically organized to facilitate Non-REA financing.

LONG-TERM LOANS TO REA BORROWERS FROM NON-REA SOURCES
AS OF DECEMBER 31, 1986
(Dollar Amounts in Thousands)

<table>
<thead>
<tr>
<th>Lender</th>
<th>Amount This Year</th>
<th>Amount Cumulative</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Financing Bank</td>
<td>$1,174,486</td>
<td>$29,824,875</td>
<td>76.6</td>
</tr>
<tr>
<td>National Rural Utilities Cooperative Finance Corp.</td>
<td>390,856</td>
<td>3,472,987</td>
<td>8.9</td>
</tr>
<tr>
<td>Other Banks and Institutions</td>
<td>8,657</td>
<td>4,152,501</td>
<td>10.7</td>
</tr>
<tr>
<td>Bank for Cooperatives</td>
<td>29,375</td>
<td>1,480,756</td>
<td>3.8</td>
</tr>
<tr>
<td>Total</td>
<td>$1,603,374</td>
<td>$38,931,119</td>
<td>100.0</td>
</tr>
</tbody>
</table>

1. Includes $1.458 million in Pollution Control Revenue Bonds guaranteed by National Rural Utilities Cooperative Finance Corp.

## EXHIBIT 7

### STATISTICAL SUMMARY OF THE RURAL TELEPHONE PROGRAM

AS OF DECEMBER 31, 1986

(Dollar amounts in thousands)

<table>
<thead>
<tr>
<th>Funds Advanced and Financing Approved by Purpose - Cumulative Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>As of</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Dec. 31, 1985</td>
</tr>
<tr>
<td>Dec. 31, 1982</td>
</tr>
<tr>
<td>Dec. 31, 1981</td>
</tr>
<tr>
<td>Dec. 31, 1980</td>
</tr>
</tbody>
</table>

III. C. THE OBJECTIVES/GOALS AND POLICIES OF RECs/RTCs


5. The REA Rural Electric Loan Program in the United States, printed by the USDA & REA, July 1988.

Rural electrification is on the threshold of a new era. Gone are the days of the past when positioning poles, stringing wire, and bringing light and energy to rural areas was the overwhelming concern of the age. Rural electrics today face an array of contemporary challenges.

While the National Rural Electric Cooperative Association (NRECA) is the policymaking institute for rural electric cooperatives, the National Rural Utilities Cooperative Finance Corporation (CFC) provides supplementary financing and financial consultation services to the nearly 1000 rural electric systems and their approximately 25 million consumers nationwide. Together, these member-owned institutes will provide the direction and set the goals and policies of rural electric and telephone cooperatives (RECs/RTCs).

Although providing dependable electric service to rural America continues to be rural electrification's chief mission, there are certain overall goals that RECs/RTCs would like to accomplish. These include:

1. Making certain that rural areas have access to the benefits of telecommunications technology.
2. Finding ways of fostering economic growth and attracting new industry to rural areas.
3. Experimenting with new approaches to producing and using electricity.
4. Developing financing programs that will continue to promote rural electrification.

One of the most important objectives of rural electrics is to provide packaged, unscrambled, satellite television programming to rural areas. Through the recently-formed National Rural Telecommunications Cooperative (NRTC), which was jointly created and initially funded by the CFC and NRECA, electric cooperatives will move into Television Receive Only (TVRO) earth station rentals and maintenance.

The TVRO has been envisioned as the information system of the future since it can be tied not only into the home television set, but also the personal home computer and the home video recorder,


2 Ibid.
where multitudes of valuable and desired materials could be stored and used at will. For example, more sophisticated ranchers and farmers could purchase various agricultural marketing services available through a vast array of satellite transponder programs. The TVRO installation and these services could be written off as business expenses.

It can be stated that the NRTC is at least beginning to accomplish its goal, since, according to the July 13, 1988, edition of Satellite Times, five of the most well known satellite programmers have signed third-party TVRO distribution contracts with the NRTC. On June 30, 1988, the NRTC reached agreements to act as a third-party distributor for Home Box Office/Cinemax, the Disney Channel, Netlink USA, Nickelodeon, and the Nashville Network. In addition to the new services, the NRTC is authorized to distribute: CNN/Headline News, ESPN, CBN Cable, Prime Time 24, WWOR, WSBK, KTLA, WGN, WPIX, KTVT, the Nostalgia Channel, USA Network, TBS, SelecTV, Home Sports Entertainment and the Country Music Channel.

In the 45th Annual Meeting Resolutions of the NRECA, the Telecommunications Committee states that:

"in recognizing the potential impact of communications technology on the continued development of the areas served by rural electric cooperatives, NRTC, NRECA and CFC should move forward aggressively with their efforts in telecommunications in the following areas:

1. Development of a national plan to ensure all Americans access to satellite signals through privately owned satellite dish systems at reasonable and equitable cost;

2. Development of programs and pilot projects to test and implement two-way data and voice satellite communications between and among the various segments of the rural electric industry;

3. Support and encourage efforts by rural electric systems who choose to market TVRO Satellite receivers in their service areas;

4. Development of education, information and training programs through the Rural Electric Cooperative Network (RECNET), the network to most efficiently deliver this programming;

5. Development of plans for a future national telecommunications network serving the needs of rural electric cooperatives."
Furthermore, the committee urges that all rural electric organizations become members of NRTC.

Another area of involvement that will be receiving considerable attention is rural participation in industrial and economic development programs for rural areas. In many rural areas across the U.S., rural electrics are coordinating with chambers of commerce, industrial development agencies, and economic planning groups to find ways of attracting new businesses to their areas. Also, rural electrics look to industrial loads to efficiently use their existing resources and make their load curves more level. Rural electric involvement ranges from full blown industrial development departments that prepare feasibility and site location studies and community evaluations for interested industries, to a one-person staff that develops competitive electric rate structures for new and existing industrial loads. The NRECA and cooperatives feel the need to push rural economic development because often no other organization is available to provide certain services or to help local small businesses.

According to the CFC 1987 District Meetings Report from the Chairman, CFC conducted a survey of its members to determine the level of participation in these projects and to assess what opportunities there might be to become an active participant. Results of the survey showed that nearly 60% of the systems that responded were involved in some type of economic or industrial development program. System involvement ranged from providing incentive rates for new industries to participation, along with local and state groups, in the attracting of new industries to rural sites. More than half of the respondents stated that CFC should get involved in rural development projects. As shown in Appendix A, "Final Results of 1987 Community Development Survey" issued by the U.S. Department of Agriculture, cooperatives are involved in many types of product or service areas such as agriculture, forestry, housing, health facilities, water/sewer and other community facilities, business or industry.

An example of the current emphasis on rural economic development can be taken from the 45th Annual Meeting Resolutions of the NRECA. The Community and Economics Development Committee initiated a resolution entitled "Rural Job Creation," which states:

"Unemployment and underemployment in rural areas is exceedingly high at a time when rural areas are suffering economic distress. The rural crisis is affecting 60 million rural residents, many of whom are members of rural electric co-ops. It is in the best interest of consumer-members and in the best tradition of the service

3 Ibid.
orientation of cooperatives for them to actively participate in jobs creation and community and economic development.

We need to bring to bear to the fullest extent possible, all of the rural electric cooperative resources we have at every level of organization to obtain maximum benefit of the expertise available within and between our Statewide Associations, the G&Ts and NRECA. Such effort will strengthen the economy of rural areas with the benefits stemming the tide of outmigration and slowing the escalation of electric rates.

We, therefore, strongly recommend that rural electric systems support to the fullest extent possible, programs gathering rural economic and job information, providing professional technical assistance, job training, job creation and placement and that these efforts be coordinated on a national level. We also request a consolidated effort by federal government agencies to assist cooperatives in this undertaking."

In order to aid in rural economic development, Sections 312 and 313 were added to the Rural Electrification Act (RE Act) on December 22, 1987. Basically, Section 312, entitled "Use of Funds," authorizes an electric borrower to invest its own funds or make loans or guarantees, not in excess of 15 percent of its total utility plant, for economic development purposes. Also, Section 313 establishes a Rural Economic Development Subaccount and authorizes the Administrator of REA to utilize funds in this subaccount to provide zero interest loans or grants to RE Act borrowers for the purpose of promoting rural economic development and job creation projects.

Another major objective that is certain to receive much attention can best be described by the theme of the CFC's 1987 series of District Meetings, which is "CFC - Full Service Utility Financing for Rural America."4

CFC offers a full range of utility financing programs to meet the specific needs of individual members. The refinancing of high interest rate Federal Financing Bank (FFB) loans for G&T members, the purchase of Rural Electrification Administration (REA) notes at a discount for two distribution systems, the provision of capital for a generating station when full federal funding was unavailable, and the unprecedented private funding of transmission facilities to wheel public power to the Pacific Northwest are just a few recent examples of CFC's lending programs to accommodate unique situations.

4 Ibid.

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CFC continues to expand and offer new programs and services to its member systems such as the equipment financing program, which offers loan funds to RECs for providing consumers with ground water heat pumps, dual-fuel furnace systems or other equipment that encourages the use of electricity over other available energy sources.

Another program that CFC has offered since 1983, the Associate Member Program, offers rural electric cooperatives the opportunity to expand into non-electric service areas such as water and waste water treatment systems, telecommunications equipment and programming, and healthcare. Associate Membership in CFC makes it possible for virtually any electric cooperative to form a subsidiary and begin to diversify into other areas of business after obtaining financing through CFC.

Finally, rural electrics are also keeping abreast of new technology. From fuel cells, heat pumps and electric thermal storage devices to fluidized bed combustion systems and underground caves filled with compressed air, rural utilities are experimenting with the latest methods of generating and using electricity. It would be impossible to discuss all the innovative projects that rural electrics maintain with the help of the scientific and utility research communities.  

The most complete summary of the future objectives and goals of electric cooperatives may be contained in Charting A New Course - An Action Agenda For Rural Electrification. It contains a report and recommendations of the NRECA Study Committee to the Board of Directors as of June 24, 1987. These recommendations are the result of an intensive period of study. The committee has spent many hours studying a wide range of detailed papers prepared by NRECA staff, CFC staff, consultants and specialists who reviewed the major issues and challenges facing the rural electric program.

The work of the NRECA Study Committee is designed to aid the NRECA in policy discussions and decision-making as it charts a new course for rural electrification. The NRECA Study Committee is comprised of the following four task forces:

1. Task Force A: Outlook for Rural America and Future Role of REA;
2. Task Force B: Distribution Issues and Demand Factors;
3. Task Force C: Generation and Transmission Issues;

\[5\] Ibid.
While the information and recommendations of each of the Study Committee task forces is complete and insightful, only the recommendations of Task Force A and Task Force D are applicable to the purpose of this report.

**Recommendations of Task Force A**

* **Recommendation A-1**: Community and economic development should be a major program objective of all rural electric national organizations, statewide, G&Ts and distribution systems. This should complement the goals of providing the best possible electric service at the lowest possible cost.

* **Recommendation A-2**: REA should be maintained and enhanced as a continuing, viable federal agency.

* **Recommendation A-2a**: Expand REA staff to maintain an adequate, qualified professional staff to perform the present and expanded functions in a timely manner.

* **Recommendation A-2b**: REA should maintain and publish up-to-date technical standards.

* **Recommendation A-2c**: REA should maintain a technical assistance staff to provide assistance to co-ops, where needed, in the interest of loan security as well as other concerns.

* **Recommendation A-2d**: REA should encourage borrower participation and input in the development and implementation of REA policies and procedures by such means as advisory boards, hearings on rules and joint meetings of borrowers at state or multi-state levels.

* **Recommendation A-3**: REA should be expanded to include rural community and economic development programs.

* **Recommendation A-3a**: Legislation should mandate the consolidation and simplification of Farmers Home Administration rural development programs (business and industry, water and waste disposal, community facilities and planning) and their transfer to REA.

* **Recommendation A-4**: Changes should be made in REA

---

6 Charting A New Course: An Action Agenda for Rural Electrification, Report and Recommendations of the NRECA Study Committee, Printed by NRECA, Washington D.C.

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policies to facilitate investment in rural development by rural electric systems. (see aforementioned Sections 312 and 313 of RE Act)

* **Recommendation A-4a:** Controls over the investment of funds should be liberalized so that REA permits borrowers to invest in community development projects up to 10% of a system's total utility plant. (see aforementioned Section 312 of RE Act)

* **Recommendation A-4b:** Through congressional mandate or other means, changes should be made in REA's present lien accommodation and subordination policy to provide an opportunity for REA-financed systems to attract private capital for rural development purposes.

* **Recommendation A-5:** NRECA should provide expanded technical, legislative and training services, and CFC should provide funding options.

**Recommendations of Task Force D**

* **Recommendation D-1:** REA loan guarantees are essential and should be maintained on a 100% basis with continued mandated access to the FFB.

* **Recommendation D-2:** Existing FFB loans should be refinanced where advantageous to the borrower.

* **Recommendation D-3:** The FFB policy on new loans relating to refinancing should be consistent with accepted financial practices.

* **Recommendation D-4:** In order to relieve the REA revolving fund of the impact of insured and guaranteed loan defaults, the following should occur: (1) appropriations should be provided to reimburse the revolving fund for defaults which have already occurred; (2) an account should be established outside the REA revolving fund to service non-performing loans and losses on restructured loans; and (3) research should be conducted on alternative ways and means to fund the account for non-performing loans and to resolve problems of borrowers in default and those facing default.

* **Recommendation D-5:** Maintain the REA revolving fund in REA.

* **Recommendation D-6:** Seek legislation to assist in maintaining the solvency of the REA revolving fund by (1) refinancing and amortizing its CBOs and (2) amortizing...
the individual Treasury notes scheduled for payment by the fund beginning in 1993.

* Recommendation D-7: The following aspects of the present REA financing program should be maintained: (1) REA's standard interest rate of 5%; (2) REA's current discretionary authority to provide hardship loans at rates as low as 2%; (3) REA's current supplemental ratios and criteria.

* Recommendation D-8: National legislation to make rural electric systems eligible to issue tax-exempt securities should not be pursued.

* Recommendation D-9: In cases where a utility which is a non-REA borrower is attempting to acquire an REA borrower, REA should (1) not permit the debt of the REA borrower to be assumed and (2) require that all obligations of the REA borrower to its G&T be satisfied.

* Recommendation D-10: REA borrowers should be discouraged from prepaying their REA-insured loans on a discounted basis.

* Recommendation D-11: No insured or FFB loans of REA borrowers should be sold in private markets.

* Recommendation D-12: In administering its loan programs REA should: (1) improve its staff services to facilitate processing loans on a timely basis and (2) assure the role of a sympathetic lender and provide assistance in cases of financial hardship, such as those being experienced by a number of systems.

* Recommendation D-13: REA should provide funding for development projects by using: (1) Section 12 deferments of interest and principal payments, (2) the interest profit which accrues from advance payments made by REA borrowers and (3) Section 5 loans.

**NRECA Study Committee Joint Recommendation**

* Recommendation: NRECA should launch a major campaign to promote and expand grass roots participation and legislative advocacy, particularly among rural electric consumers, to achieve the objectives outlined in these recommendations.

The committee recommends that NRECA expands its efforts to promote grass roots legislative advocacy because:
The rural electric program enjoys tremendous bipartisan support from the U.S. Congress. This support is directly attributable to the success of the program and the fact that consumer-owned cooperative rural electric systems exist to serve people, not to amass profits;

This consumer-based, grass roots orientation of rural electric cooperatives therefore has tremendous potential for producing a widening of participation by our members in the legislative arena at the national level;

A substantial grass roots approach in representing rural electric goals and objectives in the Congress already exists with frequent contacts made by rural electric leaders -- directors, managers and employees;

Many rural electric systems have member advisory and other committees comprised of consumers willing to take an active role in their systems. These consumers, in most cases, are very supportive of their rural electric systems and, based on their first-hand experiences, understand the benefits which rural electric systems are bringing to their communities, state and nation. These consumers would provide a natural starting point for any effort to organize grass roots involvement nationally.
BIBLIOGRAPHY

1. CFC Associate Member Program. Printed by NRUCFC.

2. CFC 1987 District Meetings: Report from the Chairman. Printed by NRUCFC.


4. Financing the Cooperatives of Tomorrow: A Seminar for Rural Electric Managers and Directors Presented by CFC. Printed by NRUCFC.


Final Results of 1987 Community Development Survey

<table>
<thead>
<tr>
<th>Type of Product or Service</th>
<th>TELEPHONE</th>
<th>ELECTRIC</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>19</td>
<td>163</td>
<td>182</td>
</tr>
<tr>
<td>Forestry</td>
<td>6</td>
<td>68</td>
<td>74</td>
</tr>
<tr>
<td>Recreation</td>
<td>53</td>
<td>130</td>
<td>183</td>
</tr>
<tr>
<td>Other Business or Industry</td>
<td>135</td>
<td>509</td>
<td>644</td>
</tr>
<tr>
<td>Housing</td>
<td>5</td>
<td>30</td>
<td>35</td>
</tr>
<tr>
<td>Health Facilities</td>
<td>12</td>
<td>12</td>
<td>24</td>
</tr>
<tr>
<td>Water and Sewer</td>
<td>13</td>
<td>85</td>
<td>98</td>
</tr>
<tr>
<td>Other Community Facilities</td>
<td>73</td>
<td>168</td>
<td>241</td>
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</table>

<table>
<thead>
<tr>
<th>Project Status</th>
<th>TELEPHONE</th>
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<tbody>
<tr>
<td>New</td>
<td>155</td>
<td>653</td>
<td>808</td>
</tr>
<tr>
<td>Expanded</td>
<td>120</td>
<td>439</td>
<td>559</td>
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<table>
<thead>
<tr>
<th>Nature of Assistance Given</th>
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<th>ELECTRIC</th>
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<tbody>
<tr>
<td>Arranging Financing</td>
<td>63</td>
<td>93</td>
<td>156</td>
</tr>
<tr>
<td>Securing or Providing Development Assistance</td>
<td>120</td>
<td>331</td>
<td>451</td>
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<tr>
<td>Securing or Providing Marketing and/or Management Assistance</td>
<td>47</td>
<td>143</td>
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<tr>
<td>Securing or Providing Plant Design and/or Other Technical Assistance</td>
<td>66</td>
<td>314</td>
<td>380</td>
</tr>
<tr>
<td>Providing Industrial Site</td>
<td>19</td>
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<td>85</td>
</tr>
<tr>
<td>Providing Office and Meeting Space, Typing, and Other Clerical Assistance</td>
<td>97</td>
<td>185</td>
<td>282</td>
</tr>
<tr>
<td>Planning Utility Service</td>
<td>117</td>
<td>859</td>
<td>976</td>
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<tr>
<td>Gave Civic Assistance</td>
<td>223</td>
<td>399</td>
<td>622</td>
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<tr>
<td>Sponsoring Time, Money, Materials or Equipment Development Assistance and Help with Planning and Work on Project</td>
<td>34</td>
<td>90</td>
<td>124</td>
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<tr>
<td>Membership on Committees, Clubs, etc.</td>
<td>131</td>
<td>239</td>
<td>370</td>
</tr>
<tr>
<td>Technical Information, Promotion, Advertising, Marketing, etc.</td>
<td>63</td>
<td>135</td>
<td>198</td>
</tr>
<tr>
<td>Providing Meeting Space</td>
<td>29</td>
<td>68</td>
<td>97</td>
</tr>
<tr>
<td>Office Help</td>
<td>20</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>Teaching, Training and Planning</td>
<td>29</td>
<td>98</td>
<td>127</td>
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</table>

<table>
<thead>
<tr>
<th>Number of Projects Served by the System</th>
<th>TELEPHONE</th>
<th>ELECTRIC</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>224</td>
<td>944</td>
<td>1,168</td>
</tr>
</tbody>
</table>

Percent of Borrowers Reporting:
- 50.0% TELEPHONE
- 61.0% ELECTRIC
- 55.4% TOTAL

Number of Borrowers Reporting:
- 496 TELEPHONE
- 584 ELECTRIC
- 1,080 TOTAL

Total Borrowers as of 3/31/88:
- 992 TELEPHONE
- 956 ELECTRIC
- 1,948 TOTAL

Source: Rural Electrification Administration, U.S. Dept. of Agriculture
III. D. THE FINANCING OF RECs/RTCs
THE FINANCING OF RECs/RTCs

According to a survey performed by Robert Gibson\(^1\), out of the 46 states that have electric cooperatives, financing practices are regulated in only 14\(^2\). The focus of regulation is normally on the setting of rates and the protection of service territories, not on the financing practices of cooperatives.

Many existing regulatory policies help minimize the cost of capital of rural electric and telephone cooperatives (RECs/RTCs). RECs/RTCs and their affiliates/subsidiaries are able to borrow money at rates several percentage points lower than their competitors in the private sector. Cooperatives can also borrow a far larger amount relative to their equity investment than most small businesses can. These unique advantages of inexpensive financing at favorable borrowing conditions are often cited as factors causing unfair competition for the private sector.

The purpose of this section is to examine the terms and conditions of loans made to cooperatives and their affiliates by the major financing institutions as well as to describe the auditing procedures used to monitor the financing practices of RECs/RTCs.

The major financing institutions are:

1. Rural Electrification Administration
2. Rural Telephone Bank
3. Federal Financing Bank
4. National Rural Utilities Cooperative Finance Corporation
5. Rural Telephone Finance Corporation

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\(^1\)Published in *Rural Electrification Magazine*, July 1985, pp. 8-16.

\(^2\)The 14 states are Alabama, Arkansas, Colorado, Delaware, Kansas, Kentucky, Maine, Maryland, Michigan, New Hampshire, New Mexico, Vermont, Virginia and Wyoming.
The Rural Electrification Administration (REA) is the primary source of financing for electric and telephone cooperatives. REA also lends to commercial telephone companies, electric companies, public power districts and other public organizations. As mentioned previously, the agency was established by Executive Order of the President as an emergency relief program on May 11, 1935, and statutory authority was provided by the Rural Electrification Act of 1936.

In 1944, Congress passed the Pace Act, indefinitely extending REA as a lending agency and establishing a fixed interest rate (2 percent) on a fixed payment schedule (maximum 35 years). Additionally, on October 28, 1949, an amendment to the Rural Electrification Act (RE Act) authorized REA to make loans to improve and extend telephone service in rural areas. The intention of this legislation was to provide all of rural America with adequate electric and telephone service. Consequently, since 1950, all loan contracts have contained an "area coverage" agreement, requiring the borrower to serve all consumers within its area, no matter how sparsely settled.

Prior to 1971, REA rural electric and telephone borrowers received virtually all their long-term financing from REA loans. In 1971, however, the Rural Electrification Act was amended to authorize the establishment of a Rural Telephone Bank to provide supplemental financing for telephone systems. Also, on May 11, 1973, by amendment to the RE Act, the REA direct loan program was replaced by the Rural Electrification and Telephone Revolving Fund and REA was authorized to guarantee loans made by non-REA lenders. This amendment also increased the standard interest rate for REA loans to 5 percent, but continued the 2 percent interest rate for borrowers meeting special statutory criteria. REA made its first commitment to guarantee the loans of other lenders for rural electrification in 1974.

In 1981, the Rural Electrification Act was amended to (1) eliminate the 2 percent interest rate for loans from the Revolving Fund except for qualifying applications received by July 24, 1981, (2) give the REA Administrator discretion to approve loans at less than 5 percent if the borrowers meet certain criteria, and (3) require the Federal Financing Bank to make loans under an REA guarantee if requested by a borrower with such a guarantee.
Rural Electrification and Telephone Revolving Fund

REA loans are funded by the Rural Electrification and Telephone Revolving Fund (the Fund) that is set up in the United States Treasury Department. As previously mentioned, the Fund was established on May 11, 1973, by amendment to the Rural Electrification Act. The assets transferred to the Fund on that day were the following:

1. all notes, bonds, obligations, liens, mortgages and property delivered or assigned to REA by borrowers, and all proceeds from the sale of these;
2. all undisbursed loan balances on loans made up to May 11, 1973; and
3. substantially all principal and interest collections on notes, bonds, judgments and outstanding loans on or after July 1, 1972;

Additionally, any further Congressional appropriations for interest subsidies and/or losses became assets of the Fund as a result of this legislation.

Appendix A illustrates how the Fund works. The majority of the initial assets transferred into the Fund were notes pledged to REA by rural electric systems for loans made by REA since the inception of the program. The payment of principal and interest directly into the Fund provides an immediate cash resource from which REA can make advances on loans made from the Fund. These loans are referred to as insured loans since they may be sold under a contract of insurance by REA.

When the cash received is insufficient to meet the demands for advances on approved loans, REA borrows funds from the U.S. Treasury under an interim note which acts as an "open-ended" line of credit. This interim note was executed by REA and the Treasury on March 31, 1976, and should bear interest at a rate fixed by the Secretary of the Treasury, taking into consideration the current average market yield of outstanding marketable obligations of the United States having similar maturities. REA is required to repay all outstanding advances and accrued interest on this note on March 31 and September 30 of each year.

REA partially funds its repayments to the U.S. Treasury by the sale of Certificates of Beneficial Ownership (CBOs) to the Federal Financing Bank (FFB), under the agreement entered into by REA and FFB on March 31, 1976. These CBOs represent an undivided interest in the mortgage notes held by REA and FFB agrees to purchase all CBOs up to amounts mutually agreed upon from time to time. These obligations will begin to mature in 2006.
While the Fund is now relying primarily on loan repayments to meet its obligations, in recent years, Congressional appropriations have helped REA to rely less on the sale of CBOs by providing appropriated funds to make up the difference between the income and the outflow of dollars from the Fund. In Fiscal Year 1984, Congress provided the first appropriations to offset interest differentials between the cost of funds from the Treasury and the 5 percent interest rate charged on new loans. Congressional appropriations for this same purpose in recent years are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Appropriations (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$198</td>
</tr>
<tr>
<td>1985</td>
<td>$216</td>
</tr>
<tr>
<td>1986</td>
<td>$99.4</td>
</tr>
<tr>
<td>1987</td>
<td>$20</td>
</tr>
<tr>
<td>1988</td>
<td>$327.7</td>
</tr>
</tbody>
</table>

In addition to providing funds for loan advances under the insured loan program and outstanding advances and accrued interest on its "open-ended" line of credit with the U.S. Treasury, assets of the Fund shall be used for the following purposes only:

1. payment of the principal on the Treasury notes transferred to the Fund on May 11, 1973. Payment on these notes will begin in 1993. Since the interest on these notes was forgiven at the time of the transfer of assets to the Fund in 1973, no interest payments are required;

2. payments of amounts to which the holder of notes is entitled on insured loans;

3. payment to the holder of insured notes of any defaulted installment or, upon assignment of the note to the Administrator at his request, the entire balance due on the note;

3Financing the Cooperatives of Tomorrow: A Seminar for Rural Electric Managers and Directors Presented by CFC. Printed by NRUCFC.

4Ibid.

5Information obtained from Valerie Haugen, Freedom of Information Assistant, REA, January 24, 1989.

6Ibid.

7Ibid.
purchase of notes in accordance with contracts of insurance entered into by the Administrator;

payment in compliance with contracts of guarantee;

payment of taxes, insurance, prior liens, expenses necessary to make fiscal adjustments in connection with the application, and transmittal of collections or necessary to obtain credit reports on applicants or borrowers, expenses for necessary services, including construction inspections, commercial appraisals, loan servicing, consulting business advisory or other commercial and technical services, and other program services, and other expenses and advances authorized in section 7 of the Rural Electrification Act of 1936 (RE Act) in connection with insured loans. Such items may be paid in connection with the acquisition of such loans or security thereof after default, to the extent determined to be necessary to protect the interest of the Government, or in connection with any other activity authorized in the RE Act;

payment of the purchase price and any costs and expenses incurred in connection with the purchase, acquisition, or operation of property related to section 7 of the RE Act.

Status of the Revolving Fund

The following information summarizes the status of the Fund as of June 30, 1988:

Electric:
Total loans outstanding $ 11.3 billion
Total guarantees outstanding $ 18.7 billion

Telephone:
Total loans outstanding $ 3.1 billion
Total guarantees outstanding $469.4 million

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8The REA Rural Electric Program in the United States, USDA & REA, July 1988.

8The REA Rural Telephone Program in the United States, USDA & REA, July 1988.
Financed by:  
CBOs $4.071 billion  
Treasury borrowings $7.865 billion  

Annual flow for Fiscal Year 1988\textsuperscript{11} ($2,368,647,050 - $2,362,764,300) $5.88 million\textsuperscript{12}

The integrity and viability of the Fund has been the subject of much discussion in recent years. The continued existence of the Fund as well as its maintenance at acceptable levels to meet current and future program financing needs are matters of great concern. There are some who have suggested privatizing the Fund by selling it or transferring its assets so that the Fund would no longer be under the control of REA or any other Federal agency. Of course, RECs/RTCs do not want to see privatization occur. Therefore, a number of proposals and recommendations intended to stabilize the Fund as the prime source of loan funds for the rural electric and telephone program have been advanced.

There are certain factors that will serve to either extend or shorten the life of the Fund. These include:

- The amount of future Congressional appropriations for interest subsidies and/or losses;
- Interest rate levels;
- Loan demand by REA borrowers;
- Loan defaults;
- Repayment of principal of $7.9 billion to the Treasury, beginning in 1993;
- Repayment of principal on CBO borrowings, beginning in 2006; and
- Pressure resulting from the Gramm-Rudman legislation.

\textsuperscript{10}As of July 31, 1988. Information obtained from Valerie Haugen, Freedom of Information Assistant, REA, January 24, 1989.

\textsuperscript{11}Information obtained from Robert Ruddy, REA Fiscal Accounting Division, March 8, 1989.

\textsuperscript{12}This figure represents the net cash flow for Fiscal Year 1988. See Appendix B (TFS Form 222 - Report on Cash Flow) for calculation.
Policies Governing Loans

The policies and procedures concerning electrification loans under the Rural Electrification Act are set forth in REA Bulletin 20-2. Generally, rural electrification loans made by REA are insured loans made under Section 305 of the RE Act for the purposes and on the terms and conditions set forth in Section 4 of the RE Act. Loan applications from distribution borrowers for distribution or transmission facilities may not exceed their needs for funds during the next two years. For power supply borrowers, loan applications should not exceed the amount of new loan funds required during the next three years.

In renewing loan applications, the amount and management of a borrower's general funds will be considered by REA on the basis of the guidelines contained in REA Bulletin 1-7, General Funds.

To make REA resources available to as many borrowers as possible, borrowers are encouraged to use internally generated funds. Borrowers that are able to obtain loans from other sources are encouraged to do so, and they may be required to obtain non-REA financing as a supplement to financing available from REA. Such supplemental loans are required to be concurrent, bear the same maturity and be amortized in the same manner as REA loans. Borrowers may elect loan maturities of 20, 25, 30 or 35 years. Other terms and conditions of these supplemental loans must be approved by REA. According to Attachment A of REA Bulletin 20-14, borrowers in either of the following categories will be expected to obtain a portion of their long-term loan funds from a supplemental financing source:

1. Borrowers who have not previously received a concurrent REA and non-REA loan and which have a:
   a. Times Interest Earned Ratio\(^{13}\) (average of highest two ratios in last three years) of 1.5 or more; and
   b. Debt Service Coverage\(^{14}\) (average of highest two of last three years) of 1.25 or more.

2. Borrowers who have received one or more concurrent REA and non-REA loans.

\(^{13}\)The calculations for the TIER, DSC and PRR ratios are described in REA Bulletin 20-14.

\(^{14}\)Ibid.
Attachment A of REA Bulletin 20-14 also states that loan proportions for concurrent loans will be based on the borrower's Plant Revenue Ratio (PRR)\footnote{Ibid.} as follows:

<table>
<thead>
<tr>
<th>PRR</th>
<th>REA percentage</th>
<th>Supplemental lender percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.01 and above</td>
<td>90</td>
<td>10</td>
</tr>
<tr>
<td>8.01 to 9.0</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>8.00 and below</td>
<td>70</td>
<td>30</td>
</tr>
</tbody>
</table>

According to REA Bulletin 20-2, REA loans are approved for the following uses:

A. **Distribution facilities**: The construction of new rural distribution facilities or systems and improvements to meet load growth requirements or upgrade the quality of electric service.

B. **Generation and transmission facilities**: REA loans may be used to finance the initial construction of generation facilities by distribution or power supply borrowers, and of transmission facilities by power supply borrowers, only under the following conditions:

   (i) Where there is no adequate and dependable source of power presently available to the consumers; or

   (ii) Where the rates offered by existing power sources result in a higher cost of power to the consumers than if the system were financed by REA.

C. **Headquarter facilities**: The purchase, remodeling, or construction and related costs of headquarter facilities.

D. **Acquisitions**: The purchase, rehabilitation and integration of existing electric facilities where the acquisition of such facilities is an incidental and necessary way of providing service to persons in rural areas who are not receiving central station service.
E. General Plant Equipment: The purchase of office, transportation, communication and working equipment and ordinary replacement made necessary by normal wear and tear.

F. Interest: Payments of interest during the period preceding the first scheduled principal payment or for a period not to exceed five years, whichever is shorter, if requested by borrower and found necessary.

G. Operations: Working capital required for the initial operation of the borrower's system.

Loan Terms and Conditions
A. Interest Payments:

Interest payments will be required in accordance with the terms of the note, bond, or other evidence of debt as set forth in REA Bulletin 20-9.

B. Scheduled Principal Payments:

Principal payments are due in accordance with the terms of the note, bond, or other evidence of debt. Generally, as provided in REA Bulletin 20-9, principal payments will begin three years from the date of the note, but may begin at a later date if there is a demonstrated need. Repayment of principal may be scheduled to begin earlier if desired by the borrower or if requested by REA. If loans are used for the acquisition of facilities already generating revenue, principal payments begin within a year from the date of the note.

C. Advance Payments:

Payments in advance of the scheduled due date may be made as set forth in Bulletin 20-9.

D. Lien on Borrower's System:

A first lien on the borrower's total system is normally required in the form of a mortgage or a deed of trust. Exceptions are:

(1) Where a borrower is unable by reason of pre-existing encumbrances to furnish a first mortgage lien on its entire system, REA may accept other forms of security.

(2) To facilitate supplemental financing, REA may agree to a common mortgage.
It must be noted that there are certain conditions under which time of payment of principal and interest may be extended. These conditions are outlined in REA Bulletin 20-5: 320-2.

**Policies Governing Guarantees**

Rural electric cooperatives may be classified as being either one of two types - distribution systems or power supply systems. This distinction becomes important because the financing of each type of system is usually derived from different sources. Specifically, while distribution systems generally obtain concurrent loans from REA and CFC, power supply systems generally receive their long-term capital from FFB or other sources, with these loans being guaranteed by REA.

Of the 985 active rural electric borrowers with outstanding loans at the end of 1986, 922 (93.6 percent) were rural distribution borrowers and 63 (6.4 percent) were rural power supply borrowers. It is safe to assume that these percentages will remain relatively constant into the future.

REA Bulletin 20-22 and REA Bulletin 320-22 set forth Rural Electrification Administration policies and requirements concerning the guaranteeing under Section 306 of the Rural Electrification Act, as amended, of loans made by legally organized lending agencies for the purpose of financing bulk power supply facilities and telephone facilities.

**Section 313 - Cushion of Credit Payments Program**

The REA proposed to amend 7 CFR Chapter XVII by adding a new Part 1709, Rural Development Loan and Grant Program, and adding Subpart B, Rural Economic Development Loan and Grant Program. The new Part will contain REA's policies, requirements and procedures covering rural development programs. The new subpart will establish policies, requirements and procedures to implement a rural economic development loan and grant program established by section 313 of the RE Act.

Section 313, Cushion of Credit Payments Program, was added to the RE Act on December 21, 1987. Section 313 establishes a Rural Economic Development Subaccount and authorizes the Administrator of REA to utilize funds in this subaccount to provide zero interest

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17 Federal Register, Volume 53, Number 208, Thursday, October 27, 1988, Proposed Rules, pp. 43442-43447.
loans or grants to RE Act borrowers for the purpose of promoting rural economic development and job creation projects that are based on sound economic and financial analysis.

Under the proposed rule, to be eligible for zero interest loans and grants, the Borrower must be current in its payments on financing provided under the RE Act, as determined by the Administrator, and must not be in bankruptcy proceedings.

According to the proposed rule, there will be a preference for providing Borrowers zero interest loans rather than grants under this program. Further, there are limitations on the uses of these funds and the minimum dollar amount provided to a Borrower will be $10,000.

The proposed rule indicates that REA will determine the terms and repayment schedule of the zero interest loan to the Borrower based on the nature of the Project. Generally, the term of the zero interest loan should not exceed 10 years. The first principal repayment installment on the zero interest loan may be deferred two years or until the Project generates sufficient cash to begin repaying its loan to the Borrower, whichever comes first as determined by the Administrator. Also, REA must approve all agreements between the Borrower and the Project.

The Proposed rule also indicates that REA will review Borrowers receiving zero interest loans or grants, as necessary, to ensure that funds are expended for approved purposes. Borrowers receiving zero interest loans must prepare, as an exhibit to their annual audit, a financial report and general accounting of all zero interest loan funds in accordance with the provisions of 7 CFR Part 1789. Also, grants provided under this program will be administered under and are subject to 7 CFR Part 3015 and 7 CFR Part 3016, as appropriate. The Borrower that receives a grant shall be subject to requirements under these regulations which cover, among other things, financial reporting, accounting records, budget controls, record retention and audits.

Finally, projects funded under the proposed rule must not result in the transfer of any existing employment or business activity from one area to another, as determined by the Administrator. This provision directly addresses the small business competition problem by attempting to avoid displacing existing business jobs. This provision apparently was added to address the concerns of several LP Gas dealers.

The proposed rule states that the zero interest loans and grants will be provided for purposes such as project feasibility studies, start-up costs, incubator projects, and other reasonable expenses for the purpose of promoting rural economic development.
The proposed rule also states that the selection and approval of applications for zero interest loans and/or grants rests solely within the discretion of the Administrator. In making this determination, the Administrator will consider factors such as:

1. The amount of supplemental grant or loan funds provided for to be provided to the Project from private sources, state and local government sources, federal government sources, the Borrower(s) or other sources of the funds.

2. A comparison of the unemployment rate in the rural area where the Project will be located to the state and National unemployment rates.

3. A comparison of the Per Capita Personal Income in the rural area where the Project will be located to state and National income levels.

4. A comparison of the number of jobs that the Project will create in rural areas to the amount of grant and zero interest loan funds requested.

5. Projects that lead directly to improving marketable skills.

6. Commitment from the owner(s) of the Project that the Project will be a Demonstration Project.

7. Projects that will be located in Rural Areas or will provide greater benefit to Rural Areas than other areas.

8. Projects that have received the endorsement or sponsorship of businesses, local business and community leaders, Associated Utility Organizations, or local, state or federal governmental organizations.

9. Projects that have received the endorsement of Certified Development Companies approved by the U.S. Small Business Administration.

10. Projects that will be organized or reorganized on a not-for-profit basis or to provide full or majority Employee Ownership.

11. Projects that in REA's best judgement have the greatest probability of success as measured by long-term job creation or retention and rural economic development.

12. Applications submitted by Borrowers that have made deposits into the Subaccount.
REA Policy on Audits of REA Borrowers

To meet the requirements of the REA mortgage, each borrower must have its financial statements audited annually by a CPA selected by the borrower and approved by REA. The borrower is required to have this annual audit until all loans made or guaranteed by REA or RTB have been fully repaid. These audits are also reviewed by REA. These audits will help REA to identify borrowers with subsidiary operations, but may not provide enough detail to prove or disprove cross subsidization between the parent organization and the subsidiary.

According to the Code of Federal Regulations (Parts 1500 to 1899, revised as of January 1, 1988), a certified and independent accountant is to perform an examination of the financial statements including tests of the accounting records and other auditing procedures that are sufficient to allow the CPA to express an opinion on the financial statements. The CPA should be alert to situations or transactions that could indicate an irregularity, or any defalcation, fraud, false report or false claim made with seeming knowledge affecting a borrower or the interest of REA. Additionally, the CPA shall report all irregularities, whether material or not, to: (1) the president of the borrower's board of directors, (2) supplemental lenders, if applicable, and (3) the Director, Borrower Accounting and Services Division, Rural Electrification Administration, U.S. Department of Agriculture, Washington, DC 20250.

It is the responsibility of the CPA to deliver a copy of the audit report and accompanying management letter to each member of the borrower's board of directors, the borrower's manager and each supplemental lender as well as the two copies required by the REA. The CPA must submit the report and letter within three months of the "as of" audit date or as soon as possible after the completion of the audit. In addition, the CPA should present the audit findings orally to the board of directors at the completion of the audit.

The CPA shall report on a comparative balance sheet, statement of revenue and patronage capital (or retained earnings, if appropriate) and statement of changes in financial position. The report shall cover all statements presented. Additionally, the CPA should report on the adequacy of disclosures in the notes to the financial statements including data on subsidiaries and affiliated

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19Communication with REA, Office of the Administrator, January 17, 1989.
companies as well as segment information (including nonregulated activities). This data could include the type of business the affiliate is engaged in, whether or not the subsidiary is wholly-owned, the amount of the investment in the subsidiary and any income or losses produced by the subsidiary.

The management letter should give an evaluation of the effectiveness and reliability of the system of internal accounting controls, comment on the adequacy and effectiveness of the borrower's accounting procedures, discuss the general condition of the records, and outline any recommendations for improvement. Further, the management letter should include comments on the adequacy and fairness of the methods used in accumulating and recording labor, material and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts. Where appropriate, comments shall be included on matters such as:

(1) Whether subsidiary plant records agree with the controlling general ledger plant accounts.

(2) Whether construction clearing accounts are cleared promptly of costs of completed construction to the proper classified plant accounts and whether depreciation was accrued on such completed construction from the dates completed plant was placed in service.

(3) Whether retirements of plant are currently and systematically recorded and properly priced.

(4) Whether all costs associated with retirements of plant are properly accounted for in the accumulated provision for depreciation accounts and comment on any unusual charges or credits to such accounts.

(5) When REA approval was not obtained for a sale requiring such approval, and when receipts from sales of plant, material, or scrap were not handled in conformance with REA requirements.

Based on our review of several 1986 and 1987 CPA audit reports involving cooperatives with diversified activities, it was determined that these reports are inadequate to identify cross-subsidization. REA acknowledges that the CPA audit provides limited data to evaluate cross-subsidies. Specifically, the CPA audit does not include cost allocation procedures between RECs/RTCs and their subsidiary operations.
In addition to the annual CPA audit, each REA borrower is required to have a loan fund and accounting review (LFAR) performed every two years. The main objective of the loan fund and accounting review is to determine whether the borrower has properly accounted for all loan funds received and that loan funds have been expended for approved purposes and in amounts approved by REA. LFARs are conducted by REA Field Accountants who live and work in various regions of the U.S. If a borrower has a wholly-owned subsidiary, REA cannot demand records unless it has loaned funds to finance the operation. The following Loan Fund Review Program information was provided by REA for Fiscal Year 1988 (10/1/87-9/30/88):

| Number of Field Accountants | 39 |
| Number of reviews completed | 828 |
| Average review time | 50-60 hours |
| Total funds advanced (includes REA, FFB and RTB loans) | $1,078.5 mil. |

Disallowance information:

<table>
<thead>
<tr>
<th>Cooperatives</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of reviews with disallowances</td>
<td>128</td>
</tr>
<tr>
<td>Dollar amount of disallowances</td>
<td>$18.45 mil.</td>
</tr>
</tbody>
</table>

| Telephone: |
|---------------|--------|
| No. of reviews with disallowances | 23 | 53 |
| Dollar amount of disallowances | $1.35 mil. | $3.2 mil. |

Total:

| No. of reviews with disallowances | 151 | 57 |
| Dollar amount of disallowances | $19.8 mil. | $6.7 mil. |

Basically, REA Field Accountants test to ensure that loan funds have been advanced in compliance with 7 CFR 1711.1. When insured loan funds are found to have been advanced in noncompliance with this rule, Borrowers will be required to return the appropriate amount of the over advance together with any accrued and unpaid interest to REA. The Administrator will require borrowers, in order to remedy such noncompliance, to pay an additional amount equal to the interest on the funds over advanced for the period such funds were outstanding, calculated at a rate equal to the difference between the REA loan interest rate and the most recent rate at which REA sold Certificates of Beneficial Ownership (CBOs).

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Information obtained from William E. Davis, Director, REA Borrower Accounting Division, November 23, December 21, 1988, and January 24, 1989.
During the course of a LFAR, the REA Field Accountant may find that loan funds have been disbursed for unapproved purposes not related to noncompliance with 7 CFR 1711.1. These are referred to as "normal" unapproved disbursements. Examples of these unapproved disbursements include:

1. Duplicate reimbursements to general funds (i.e., the same work order inventory or special equipment summary used twice to support disbursements of loan funds).

2. Work orders and/or special equipment summaries include costs which are not properly capitalized, and therefore are not to be financed from loan funds.

3. Work orders and/or special equipment summaries include costs that are properly capitalized, but which cannot be financed from loan funds unless prior approval has been specifically given by REA. Examples would be used equipment, remanufactured or rebuilt transformers, rotoversers, and Interest During Construction.

When an unapproved loan fund disbursement occurs, the borrower will be required to:

1. Return the amount of the unapproved disbursement to the REA Construction Fund Account immediately, and

2. Disburse the funds from the REA Construction Fund Account only for approved purposes in accordance with 7 CFR 1771.1.

Funds advanced in noncompliance with 7 CFR 1711.1 and unapproved disbursements are both considered "disallowances" by the REA Borrower Accounting Division. As can be seen above, "disallowances" were detected in approximately 1/4 of the REA LFARs conducted in Fiscal Year 1988. It must be noted, however, that REA is not aware of any disallowances involving the use of REA funds for diversified, non-utility activities, although LFARs could

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21Information obtained from an informal communication with Tom Toye, Deputy Director of REA Borrower Accounting Division, February 3, 1989.

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detect such unapproved uses.\textsuperscript{22}

\footnote{\textit{Information obtained from an informal communication with William E. Davis, Director, REA Borrower Accounting Division, March 14, 1989.}}
RURAL TELEPHONE BANK

General

On May 7, 1971, the Rural Electrification Act was amended to establish the Rural Telephone Bank (RTB). RTB was established as a lending agency operating in conjunction with REA to provide supplemental financing for the REA telephone loan program. RTB utilizes the facilities of REA and other agencies of the Department of Agriculture free of charge. It is a self-sustaining agency and is subject to the Government Corporation Control Act.

Sources of Funds

I. Capitalization

The capital stock of the bank consists of three classes:

Class A - issued only to REA; 2 percent return per annum; cumulative
Class B - issued to loan recipients; one vote per holder; no dividend; entitled to patronage refund based on the amount of interest paid during year
Class C - issued to eligible borrowers; one vote per holder; dividend shall not exceed the current average rate payable on telephone debentures

A special fund of RTB is available into which those not able to buy stocks of RTB can pay. This special fund equivalent gives them the rights and obligations identical to Class B or C stockholders.

II. Borrowing Power

A. RTB is authorized to obtain funds through the public or private sale of its telephone debentures. RTB seldom utilizes this source of funds.23

B. RTB is also authorized to issue telephone debentures to the Secretary of the Treasury. Every purchase of telephone debentures shall be upon such terms and conditions as to yield a return at a rate not less than a rate determined by the Secretary of Treasury, taking into consideration the current average yield on outstanding marketable obligations of the United States.

23Information obtained from an informal communication with Bob Peters, Deputy Assistant Administrator - Telephone, REA, January 25, 1989.
of comparable maturity. Although RTB does utilize this source of funding, RTB has not borrowed from the Treasury for at least two years.\textsuperscript{24}

Financing Activities

I. Loan Program

Loans are made for the purpose of financing or refinancing the construction, improvement, expansion, acquisition and operation of telephone lines, facilities or systems. Section 408(a) of the RE Act lists restrictions applicable for such purposes.\textsuperscript{25}

RTB will consider making a loan for an applicant's total loan needs as well as concurrently with REA when REA has requested that the applicant obtain a loan for part of its credit needs from a source other than REA. The applicant, however, must be able to produce net income or margins before interest at least equal to the aforementioned 150 percent of the interest requirements on all its outstanding and proposed loans, including an annual interest rate on the loan for its current needs.

All loans are fully amortized over a period not to exceed fifty years. The interest rate charged on loans from RTB cannot be less than 5 percent per annum. Furthermore, loans usually bear interest at the cost of money rate prevailing at the time of the advance.

\textsuperscript{24}Ibid.

\textsuperscript{25}Ibid.
General

The Federal Financing Bank (FFB) is the vehicle through which most Federal agencies finance their programs involving the sale or placement of credit market instruments, including agency securities, guaranteed obligations, participation agreements and loan assets. FFB was created to ensure the coordination of Federal and federally assisted borrowing from the public and to assure that such borrowings are financed in the manner that is least disruptive to private financial markets and institutions.

FFB was established by the Federal Financing Bank Act of 1973, which was passed into law on December 29, 1973.

Source of Funds

FFB obtains its funds by issuing obligations to the U.S. Treasury. Such obligations bear interest rates based on estimated Treasury new issue rates. FFB matches the terms and conditions of its borrowings from the Treasury with the terms and conditions of its loans.

Financing Activities

Lending by FFB to Federal agencies and to guaranteed borrowers can be accomplished by three means: (1) FFB may purchase agency financial assets; (2) FFB may make direct loans to and receive payments from borrowers on behalf of the agency; and (3) FFB may acquire debt securities that the agency is otherwise authorized to issue to the public.

FFB loans funds at the lowest interest rate possible in any amount required and for any maturity. The lending policy is so flexible that the agencies do not have to worry about accumulating excess cash. This does not include normal liquidity reserves.

FFB lends funds at a rate 1/8 percent above the new issue curve of marketable U.S. Treasury securities. Additional charges are made for loan provisions which increase FFB's costs at the Treasury or for extraordinary services which increase administrative costs. Borrowers are charged an additional fee of 3/8 percent per annum on all new borrowings after September 30, 1987. The fee is what borrowers would have incurred had they issued obligations in investment securities markets held by the public. These fees are returned to the General Fund of the Treasury.
FFB's policy concerning service charges is that they are borne by the borrowing agency. Therefore the low rates quoted by FFB are net of servicing costs. Loan rates are ordinarily set by FFB at the time of fund disbursement. In cases where borrowers desire future rate commitments, extra costs will be incurred by the borrower. In this way, FFB protects itself as well as the Treasury from financial loss.

If the borrower or guaranteeing agency agrees to finance solely with FFB, it will assure the availability of funds without fee at an interest rate determined at the time the loan is made.

FFB also offers lines of credit for 91-day periods at a fixed charge above the 91-day Treasury bill rate for advances made during the period. Additionally, FFB purchases guaranteed tax-exempt issues from the federal agencies, provided the purchase results in lower costs to the federal agencies than if issued through other avenues. The rates for such purchases can be negotiable.

According to the U.S. Treasury Department's Appendix to the Budget for Fiscal Year 1988, in 1986, FFB had $4.241 billion in loans outstanding due to assets (CBOs) purchased from the REA and had $21.459 billion in REA originated loans (guaranteed by REA) outstanding. In addition, the Treasury estimated that loans outstanding due to purchased assets would be approximately $3.537 billion in 1987 and $2.132 billion in 1988. REA originated loans outstanding were estimated to be approximately $21.39 billion and $22.486 billion in 1987 and 1988, respectively.
General

The National Rural Utilities Cooperative Finance Corporation (CFC) is a nonprofit, cooperative financing institution, owned and controlled by its nearly 1,000 rural electric member systems and their affiliates. CFC is a private financing organization that was formed after two attempts to establish a Federal Rural Electric Bank through Congressional channels had failed. Control is exercised through a 22-member Board of Directors elected by the membership.

Incorporated in April 1969, CFC's primary objective is to provide financing through a number of loan and loan guarantee programs designed to meet the varied capital needs of its members. CFC also provides related service programs designed to assist members in various aspects of financial planning and services. Since its incorporation, CFC has grown into a recognized financing institution with 1987 assets of $3.54 billion.

Sources of Funds

I. Equity - Members invest in CFC primarily in the following four ways:

1) Membership Fees - Upon joining the CFC, each member must pay a one time, non-transferrable fee;

2) Subscription Capital Term Certificates - These member investments comprise the largest portion of CFC's equity base;

3) Loan and Guarantee Certificates - These are required as a condition for obtaining loans and guarantees;

4) Patronage Capital - These certificates are issued annually to systems that have paid interest on their outstanding loans during the year.

II. Collateral Trust Bonds - Long-term debt instruments backed by a pool of mortgages (collateral) of RECs that have received long-term loans from the CFC.

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III. CFC Commercial Paper - Interested RECs/RTCs purchase commercial paper directly through the CFC Money Desk. CFC's commercial paper is backed by lines of credit and revolving credit agreements from many domestic and foreign banks. Therefore, CFC commercial paper receives the highest ratings from both Moody's (Prime-1) and Standard and Poor's (A-1+).

Membership Classification

Class A - Distribution systems that carry electric power directly to consumers, farms and businesses.

Class B - Power supply systems that generate and provide electric power to distribution systems.

Class C - State-wide and regional rural electric cooperatives, data processing service centers and material supply cooperatives that provide services to Class A and B members.

Class D - National organizations that belong to CFC. (to date, National Rural Electric Cooperative Association is CFC's only Class D member).

Associate Member - Nonprofit organizations owned and controlled by a Class A member to provide nonelectric services, such as telecommunications and water services, to rural residents in the member's service territory.

Financing Activities

I. Loan Programs

CFC provides a variety of loan programs to meet the capital needs of its member rural electric systems. These include the following:

1. Long-term Loans

These loans are to finance land and equipment acquisitions, construction of facilities, and the purchase of materials and equipment. In order to be eligible for long term loans, CFC requires that systems maintain minimum financial standards as measured by the TIER and DSC ratios. CFC requires that distribution systems and power supply systems maintain TIERs of 1.5 and 1, respectively. Additionally, CFC requires a DSC

27The calculations for the TIER and DSC ratios are described in REA Bulletin 20-14.
of 1.25 or more for distribution systems and 1 or more for power systems. It should be mentioned that these ratios are calculated as an average of the best two ratios of the preceding three years. The types of long term loans include:

(a) Concurrent Loans

Distribution systems usually obtain 70, 80 or 90 percent of their long-term funding needs from REA, with CFC providing the additional 30, 20 or 10 percent of the loan amount. Since CFC long-term interest rates are generally higher than the rate charged by REA, members are encouraged to obtain as much of their capital as possible from REA. Relative productivity of the plant as measured by Plant Revenue Ratio (PRR)\(^{26}\) is the factor used by REA in determining the proportion of the loan obtainable from REA. Loans terms are from 20 to 35 years and loans are secured by a CFC/REA common mortgage which gives both lenders a first lien position, on a ratable basis, on the borrowing system's revenues and assets.

Power supply systems, on the other hand, generally obtain their financing from Federal Financing Bank, an agency of the U.S. Department of Treasury. These loans are guaranteed by REA. CFC may make concurrent loans to these power supply facilities if they are eligible for financing from the REA Revolving Fund.

(b) "One Hundred Percent" Loans

Members may request that CFC fund their entire loan if the loan is not available from REA. These loans are secured by a first mortgage lien on the system's assets.

2. Intermediate-term Loans

These loans are for interim project financing and for the financing of projects with a shorter asset life (1 to 5 years). Security is usually required in the form of a first lien on the property or project being financed. For Class A and B members, no additional equity investments are required.

3. Lines of Credit

These loans are used to meet daily cash requirements and operating expenses, and are generally made on an unsecured

\(^{26}\)The calculation for the PRR ratio is described in REA Bulletin 20-14.
basis. The interest rate is based on CFC's cost of short-term capital and is never higher than 1 percent above the existing prime rate. Interest accrues only on amounts outstanding and no commitment fees are charged. No additional equity investments are required.

4. Letters of Credit

This is an alternative to a surety bond for Class A, B and C members for facilities crossing public land. CFC issues these for land reclamation and other projects that may require a firm credit commitment. An annual fee is charged.

II. Guarantee Programs

A. Guaranteed Tax-Exempt Issues

For nearly a decade, rural electric systems have been financing required pollution control facilities on their power plants through the issuance of tax-exempt bonds by municipalities or other government units. Tax-exempt financing means a lower cost of interest than current taxable market rates. An even lower cost of interest is realized with CFC's guarantee supporting these issues. Since CFC guarantees to make bond payments should its members default, members can get a better rating on their bonds and thus obtain financing at a lower interest cost. CFC currently guarantees three types of tax-exempt issues: single issue long-term bonds, a pooled series of long-term bonds, and floating/fixed rate bonds.

CFC requires systems to purchase equity certificates in an amount equal to 5 percent of the principal guarantee amount. An additional percentage of the principal amount must be invested in a Debt Service Reserve Certificate. An annual fee is charged for servicing the guarantee and other ongoing expenses.

B. Leases

For cooperatives, leasing is often a more economical way to pay for assets than straight debt financing. Through a CFC affiliate, National Cooperative Services Corporation (NCSC), rural electric systems (which have little or no tax liability) lease assets from an organization with a large tax indemnity. The tax benefits realized are then passed on to the leasee (the cooperative). CFC's involvement is both direct and indirect. CFC makes loans to NCSC and guarantees NCSC's debt issues when permanent long-term financing is appropriate.
III. Cooperative System Integrity Fund

In 1986, the CFC Board established a fund to help protect rural electric cooperatives threatened with hostile takeover attempts by competing utilities. Contributing members make annual contributions of 5 percent of their annual patronage capital refunds, which are held by CFC for five years and invested in CFC commercial paper until needed. Funding for any individual system is limited to 10 percent of the total fund. At the end of the five year period, the amount contributed, plus interest, is returned to the systems, less a pro rata share of any funds expended.

IV. Associate Member Program

In February 1983, the CFC membership, through the enactment of a bylaw amendment, approved the establishment of an Associate Member Program to enable rural electrics to engage in service ventures other than the electric utility business. All eligible member systems are now allowed to establish new subsidiaries to provide such services as water and waste water treatment, health care, transportation, and telecommunications.

As of December 1988, CFC has approved 34 Associate Member projects as well as $45.7 million in loans for these projects. Only 20 of the approved ventures have actually drawn funds, however, since not all of the members chose to proceed with their approved projects. These 20 projects have $28.1 million in loans outstanding. Further, 14 of these 20 Associate Members have drawn funds for telecommunication-related projects such as CATV or satellite TV programming and equipment. 5 Associate Members have borrowed funds for water and sewer projects and 1 Member has drawn funds for an economic development program. 29

CFC offers Associate Members the following types of loans:

1. Revolving Credit Loans

These loans are available to Associate Members for periods of up to five years and are designed to meet front-end costs associated with the planning and engineering of certain projects. Establishing security for lines of credit requires a guarantee of up to 10 percent of the owning or controlling rural electric's

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29 Information obtained from an informal communication with Michael Sorohan, CFC Member Relations & Education Manager, December 22, 1988.
total utility plant or 50 percent of its total equity, whichever is greater, and a first mortgage lien on all of the Associate Member's assets. No equity investment is necessary for revolving credit loans, and in November 1988, CFC's standard short term interest rate was 8.75 percent.

2. Term Loan

Term loans are used for actual construction or implementation of Associate Member projects and may be of variable duration, from intermediate to long-term. To establish an equity base for these loans, each borrower must invest in CFC's Capital Term Certificates (CTCs) equal to 10 percent of the loan value. This equity does not earn interest and is retained by CFC until the loan matures. Establishing security on term loans requires a first lien on all of the Associate Member's assets and, in most cases, a guarantee of up to 10 percent of the total utility plant of the sponsoring rural electric system or 50 percent of its total equity, whichever is greater. CFC blends its cost of funds with Associate Members' zero-cost equity to obtain the interest rate charged on these loans. This rate is adjusted monthly.

V. Financial Services

Besides the lending and other financing programs provided for its members, CFC also offers a variety of financial consultation and cash management services. These services include:

1. Commercial Paper Investment Program and Paying Agent Service for members who wish to put their temporarily excess funds to work for them;

2. Rate and Regulatory Consultation to assist with regulatory filings and testimonies;

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30 Information obtained from an informal communication with Kathy Buhl, Senior Loan Examiner, CFC, February 2, 1989.

31 Information obtained from an informal communication with Michael Sorohan, CFC Member Relations & Education Manager, November 1, 1988.

32 Information obtained from an informal communication with Kathy Buhl, Senior Loan Examiner, CFC, February 2, 1989.
3. Financial Consultation with a field staff of ten CFC Area Representatives for on-site discussions with members regarding financial planning and management;

4. Investment Advisory Services for members with nuclear decommissioning funds or proceeds from tax-exempt bond sales; and,

5. Financial Management Assistance Programs such as the Key Ratio Trend Analysis, the G&T TREND Analysis, Power Supply Symposium, and various financial seminars.
RURAL TELEPHONE FINANCE CORPORATION

General

The Rural Telephone Finance Corporation (RTFC) is a not-for-profit cooperative that was established by CFC to provide lending and other financial services to cooperative and commercial independent rural telephone and telecommunications systems, and to their affiliated organizations. RTFC's objectives are to add "private market" capability to the financing programs historically offered by REA through the insured loan program and through RTB.

RTFC offers an alternative funding source for rural Telcos that complements traditional lending programs. RTFC provides financing for projects not authorized by the Rural Electrification Act or for projects that REA will not finance. Eligibility for membership is open to (1) systems which have received or are eligible to receive loans from REA or RTB, or (2) their closely affiliated organizations such as holding companies. While RTFC will not refuse to consider applications for purposes for which REA or RTB could or would make funds available, the RTFC staff will counsel such applicants regarding the possible availability of REA or RTB loan funds.

Financing Activities

I. Loan Programs

A. Long-term Loans

Rural telephone loans may be made "to persons now providing or who may hereafter provide telephone service in rural areas, to public bodies now providing telephone service in rural areas and to cooperative, nonprofit, limited dividend, or mutual associations... for the purpose of financing the improvement, expansion, construction, acquisition, and operation of telephone lines, facilities or systems to furnish and improve telephone service in rural areas." 33

These loans may be used for refinancing RTB loans, refinancing vendor or commercial bank debt, purchasing acquisitions, financing deregulated enterprises such as toll

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networks and cable television systems, and upgrading existing plants. Long-term loans will normally be secured by a first mortgage lien on assets and by revenues equal or superior to liens of other creditors. Loans may be made for terms of up to the life of the assets financed and will be amortized over the life of the loan, generally not to exceed fifteen years.

Capital certificates equal to 10 percent of the loan amount must be purchased and invested in RTFC. One half of this equity requirement (5 percent) matures at the maturity of the loan. The remaining 5 percent is amortized on three-year intervals to maintain a 5 percent certificate-to-outstanding loan ratio. Amounts amortized are used to reduce the outstanding principal balance on the loan or are returned as a cash payment if the loan is paid in full. There is no amortization of the equity certificate until the loan principal has been fully drawn down and the full 10 percent equity certificate has been purchased. The system either purchases the equity certificates using its own funds (with purchases in twelve equal quarterly installments) or the equity certificate is included in the loan amount and is purchased with each advance of funds.

Currently, the interest rate charged on long term loan varies monthly and is based on RTFC's cost of short-term debt. A fixed rate based on the cost of long-term debt to RTFC will soon be available.

B. Short-term Loans

Short-term line of credit loans are generally made for seasonal cash flow needs and may also be used to finance capital additions while awaiting long-term financing. The system must have maintained a DSC (debt service coverage) ratio of at least 1.25 during each of the previous three years, and must produce a certified 5 year financial forecast. Lines of credit normally will be made available on an unsecured basis for terms of up to 5 years. The loan amount is limited to the greater of 5 percent of total assets or 25 percent of equity in excess of 35 percent of total assets.

There are no equity requirements or commitment fees required in the RTFC short-term loan program. Borrowers are

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Andrea Robel, Senior Loan Analyst, RTFC, stated in an informal communication on December 22, 1988, that the RTFC does indeed loan funds to RTCs that wish to diversify into CATV. She was not, however, willing to disclose the amount of funds advanced for CATV ventures.
required, however, to reduce line-of-credit balances to zero at least once in each twelve-month period. Funds may be drawn down and repaid on a revolving basis, with interest charged only for the period funds are held by the borrower.

The interest rate charged on line-of-credit will vary based on changes in RTFC's cost of short-term funds, but it will not exceed prime plus one and one-half percent.

II. Investment and Cash Management Programs

RTFC members and their affiliates will receive preferred treatment when purchasing commercial paper from CFC. CFC commercial paper is a short term promissory note that earns competitive, money market rates for rural utility investors. Investment terms are from 1 to 270 days, with a $5,000 minimum investment and $1,000 additional increments above the minimum. CFC Commercial Paper carries the highest ratings awarded by Moody's Investors Service and Standard and Poor's Corporation: Prime-1 and A-1+, respectively.

RTFC members can also take advantage of CFC's Paying Agent Service to pay creditors with proceeds from commercial paper investments or through line-of-credit advances. Through this program, CFC will make payments on behalf of RTFC members to REA or RTB to meet debt service payments, to RTFC for debt service payments, and to other creditors where use of the service is agreed upon by all parties. The minimum amount for each transaction is $5,000. Use of the Paying Agent Service enables participating systems to keep funds invested and earning interest in CFC Commercial Paper until the day payment is required.

III. Advisory Services

A core of RTFC field representatives, strategically located across the country, is available to advise members on the use of RTFC/CFC programs and services and on the financial operations of their systems. Furthermore, advisory services relating to rate and regulatory issues and to leasing and other special financing vehicles are available upon request.
1. 7 CFR Ch. XVII (1/1/88 Edition), Part 1711, REA & USDA.
3. CFC 1987 District Meetings: Report from the Chairman. Printed by CFC.
4. CFC 1987 District Meetings: Report from the Governor. Printed by CFC.
5. CFC - Financing for Rural Electrification: An Introduction to the Policies, Programs, and Services of CFC. Printed by CFC.
6. CFC Commercial Paper: An Investment in Rural America. Printed by CFC.
7. CFC's Financial Terms and Definitions. Printed by CFC.
8. CFC Associate Member Program. Printed by CFC.
9. CFC Full Service Utility Financing for Rural America. Printed by CFC.
13. Financing the Cooperatives of Tomorrow: A Seminar for Rural Electric Managers and Directors Presented by CFC. Printed by CFC.
15. Guidelines for the Implementation of 7 CFR 1711.1 Electric Loans, November 2, 1988, REA & USDA.


25. REA Loans and Loan Guarantees for Rural Electric and Telephone Service. Printed by USDA & REA.

26. The REA Rural Telephone Loan Program in the United States, July 1988. Printed by USDA & REA.

27. The REA Rural Electric Loan Program in the United States, July 1988. Printed by USDA & REA.


HOW THE REVOLVING FUND WORKS

CASH FLOW

- Guaranteed Loans
- Insured Loans
- Section 4 Loans
- Loan Advances
- Payments on Defaults
- P & I Payments
- P & I Repayments
- Current Interest Proceeds
- Principal on Mortgage Notes (Begin 1993)
- Principal Repayment (Begin 2006)
- Direct Congressional Appropriations
- Treasury Interim Note
- Treasury General Account
- Advances
- Proceeds

$5.9 Billion Electric Loans Outstanding
May, 1973
(Seed Equity for Starting Fund)

Source: Financing the Cooperatives of Tomorrow, National Rural Utilities Cooperative Finance Corporation
APPENDIX B
### Report on Cash Flow

**Identification:** USDA-REA

**Department/Agency:** RETF

**Bureau/Organizational Unit:** RETF

**OMB Identification Code:** 12-4230-0-3-271

**Fund Type:** 1

#### Table

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<tr>
<th>Description</th>
<th>Total</th>
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<tbody>
<tr>
<td>1. Fund balance with Treasury and cash, beginning of period</td>
<td>(4,328,627)</td>
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<td>2. Sources of funds:</td>
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<tr>
<td>a. Increase in debt</td>
<td>(2,093,605,948)</td>
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<td>b. Appropriations</td>
<td>327,675,000</td>
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<td>c. Revenue</td>
<td>2,368,213,148</td>
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<td>d. Sale of assets</td>
<td>575,242,905</td>
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<td>e. Increase in payables</td>
<td>1,191,121,945</td>
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<td>f. Decrease in receivables and advances</td>
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<td>g. 1. Other</td>
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<tr>
<td>2. Application of funds:</td>
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<td>a. Operating expenses</td>
<td>2,313,812,549</td>
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<td>b. Less: Expenses not requiring outlays</td>
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<td>c. Increase in investments</td>
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<td>d. Increase in inventory</td>
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<tr>
<td>e. Purchase of property and equipment</td>
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<td>f. 1. Other Deferred Interest</td>
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<td>2. Prior Year Adjustment</td>
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<tr>
<td>g. Total</td>
<td>2,362,764,300</td>
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<tr>
<td>4. Fund balance with Treasury and cash, end of period</td>
<td>1,554,123</td>
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**Agency Contacts:**

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III. E. THE REGULATION OF RECs/RTCs AND SURVEYS THAT SUMMARIZE THE REGULATION OF RECs AND RTCs
THE REGULATION OF RECs/RTCs

Since the regulation of a diversified cooperative can differ greatly from the regulation of one which chooses not to diversify, regulators may be presented with significant problems and issues. One regulatory problem associated with diversification is cross-subsidization, which occurs when costs are unevenly allocated to the regulated utility to the benefit of the subsidiary. The end result of cross-subsidization is that it gives the subsidiary an unfair advantage over its competitors, many of whom are small businesses that may be driven out of business. The low-interest loans available to cooperatives complicate this regulatory issue even more. In addition, cooperative diversification can affect rates as well as the supply and price of other goods and services available to customers. Further, disputes may arise over regulatory access to the books and records of the diversified activities. Finally, cooperatives may become more concerned with their diversified businesses. All of these are challenges which regulators must address.

This section examines the extent of the regulation of rural electric and telephone cooperatives (RECs/RTCs). The role of state public regulatory commissions, the Federal Trade Commission and antitrust legislation will be discussed. In addition, the results of three national surveys concerning regulation of RECs/RTCs will be presented.

Survey 1 was designed to identify the agencies that are responsible for REC/RTC regulation and is particularly interested in ascertaining whether or not the diversification efforts of these systems are regulated. Additionally, the regulatory organizations are asked to provide a list of complaints and/or legal proceedings brought by small businesses against RECs/RTCs concerning "cross-subsidization," "unfair competition," and "antitrust."

Survey 2 relates to the regulation of rates, financing, and service areas of rural electric systems. Survey 3 concentrates on the regulation of REC rates.

State Commission Authority

The theoretical and practical justification of our competitive market economy is that it brings about the most efficient resource allocation consistent with the basic economic freedom that our society demands. The purpose of regulation is to obtain for the public the benefits that would be achieved by competition.

From the viewpoint of public utility regulation, public utilities comprise one part of a general class of business which are distinguished as "business affected with a public interest." Utilities often are referred to as natural monopolies. That is, a single firm can provide service at a lower cost per unit than could
two or more firms. Granting only one firm the right to provide a particular service enables that firm to have a large degree of monopoly power. The objective of regulation is to secure the efficiency of monopolistic operation without allowing the company to take advantage of its position. Regulation becomes a substitute for the economic controls of competition in assuring fair prices and adequate service.

Four principal activities in regulation are:

(1) The determination of the revenue requirements which public utilities are allowed but not guaranteed;

(2) The control of entry into market areas. Utilities are enfranchised by government and have the right of eminent domain, and therefore, are free from business competition to a substantial degree;

(3) The requirement to provide adequate service to the entire public on demand; and

(4) The establishment of standards related to the quality and conditions of service.

The regulation of cooperatives is a matter primarily handled at the state level, usually by a state's Public Utility Commission (PUC) or Public Service Commission (PSC). These Commissions are charged with establishing utility rates and reviewing the data used to justify particular rate requests.

In examining utility diversification issues, the scope of the state regulatory inquiry is often limited to a scrutiny of the effect of the utility diversification on ratepayers. Specifically, the state regulator seeks to ensure that the ratepayers are not called upon to subsidize non-utility businesses and to make certain that diversified business activities of the utility do not threaten the financial integrity of the cooperative.

Responsibility to ratepayers is therefore the primary function of state commissions and they may not have the authority, the resources, or the inclination to respond to complaints about the damage invoked on small business competitors of the cooperative -- unless ratepayers are also injured. Thus, in the case of rural electric and telephone cooperatives, where the ratepayers are the owners of the cooperative themselves, state commissions tend to be even more hesitant to intervene.

Our surveys indicate that the majority of the cooperatives are not regulated by state commissions. If a cooperative is regulated, issues of cross-subsidy may be raised in general rate cases filed by that cooperative. It is at that time that the commission conducts a full audit of the cooperative to ensure that cost
allocations are being handled correctly. Once the commission sets customer rates based upon the correct allocations, these rates remain in effect until the cooperative submits another rate case, or one is initiated by the customer or commission complaint. Therefore, at any particular point in time, the rates being paid by ratepayers mirror the commission's opinion of the proper allocation of costs between utility and non-utility business as evidenced in the previous rate case.

Between rate cases, new allocation problems may occur. While these are adjusted in the next rate case, they are not generally adjusted in the interim. Commissions, for the most part, do not engage in full audits between rate cases. Great additional burden would have to be shouldered by the commission if it were to attempt to properly monitor transactions between utility and non-utility businesses. It is recognized that regulatory staff time is limited due to budgetary constraints. Furthermore, the expense of properly monitoring affiliate transactions or conducting full audits may exceed the benefits borne by ratepayers.

Further complicating the process is the risk that commission staff may be denied access to books or records of the non-utility business.

The best method of assuring that state regulatory commissions have the authority to oversee cooperative rates, financing and diversification is to seek legal authority through the legislative process. However, as our surveys indicate, the majority of states have not adopted the necessary legislation to allow proper regulation of cooperatives.

The conclusion that can be drawn from this discussion is that a regulator's outlook on diversification may ultimately rest on his basic perception of the purpose of regulation, although this perception should be consistent with the specific legal requirements of the state in which he operates. A regulator may choose either extreme on the regulatory spectrum. He may define utility monopolies strictly or give the utility free reign to do whatever it wishes with excess funds, or he may take the middle road by encouraging innovation as long as it is in the ratepayer's or public's best interest.

There are several strategies available to regulators who find themselves in the latter position. A regulator could review every diversification proposal in detail and evaluate it to determine whether or not it would be a wise business venture. The problem with this strategy is that it would make the regulator and the cooperative partners in diversification, therefore allowing the cooperative to use the "state action defense." Furthermore, it is doubtful that any state commission has the resources to make a thorough analysis for every diversification application.
On the other hand, the state commission could analyze in more general terms the area of activity into which the REC/RTC would like to diversify. In this case, the commission would give its approval provided the REC/RTC offered plausible reasons as to why diversification into a particular business would be helpful.

Another possible strategy that could be utilized by regulators would be to periodically review the cooperative's diversification activities. For example, regulators could specify reporting requirements or attempt to control money flow from utility businesses to non-utility businesses. Obviously, it would be very important to explicitly state the conditions required before the diversification occurs.

In some states, cooperatives may be regulated under an affiliated interest statute, which is usually an agreement reserved for privately-held utilities. Affiliated interest agreements are contracts which cover transactions between a utility and its subsidiaries. There are two regulatory procedures available for states which require affiliated interest agreements. With both procedures, the filings usually provide the commission staff with information on contract terms and prices of transactions between the utility and its subsidiaries.

The first procedure is an affiliated interest filing statute. Under this type of statute, the utility files an affiliated interest agreement and the agreement becomes effective. With this procedure, affiliated agreements must be filed for all transactions between the utility and its subsidiary no matter how insignificant the dollar amount involved. The commission can then monitor the number and frequency of the affiliated interest agreements in order to determine the level of interrelation between the utility and its subsidiaries.

The second procedure is an affiliated interest pre-approval statute. Under this approach, the utility's regulatory agency must approve any agreement before it can take effect.

According to the survey conducted by SVL Associates, there are 18 state regulatory commissions that have the authority to regulate the rates of RECs and 21 commissions that have the authority to regulate the rates of RTCs. There are only a few states that have enacted legislation that is applicable to the regulation of cooperative diversification. The states include Maine, New Mexico, Ohio, Texas, Vermont, Virginia and West Virginia. Evidence suggests that cooperatives in these states are regulated under various state affiliated interest statutes. However, only the state of Virginia has applied an affiliated interest statute to actually review the diversification plan of a REC/RTC. While the affiliated interest statutes do indeed exist and are applicable to RECs/RTCs
in the other six states, none of these states reported reviewing an actual case concerning a cooperative.

Following are brief descriptions of state statutes and regulations that deal with state commission regulation of utilities with subsidiaries and affiliates.

In Maine, Title 35-A M.R.S.A., section 102(5), defines "electric utility" to include the four RECs in the state. Further, REC diversification (the state of Maine has no RTCs) is regulated by Title 35-A M.R.S.A., sections 707 and 708. These sections deal with transactions between affiliated interests (section 707) and reorganizations of and by utilities (section 708).

Sections 707 and 708 of Title 35-A are interrelated. Section 707 basically defines the term "affiliated interest" and states that no public utility may extend or receive credit or make or receive a loan to or from an affiliated interest or make any contract or arrangement for the furnishing of management, supervision of construction, engineering, accounting, legal, financial or similar services, or for the furnishing of any service other than those enumerated with any affiliated interest until the Commission finds that the contract or arrangement is not adverse to the public interest and gives the contract or arrangement its written approval.

Section 708 defines a "reorganization" as any creation, organization, extension, consolidation, merger, transfer of ownership or control, liquidation, dissolution or termination, direct or indirect, in whole or in part, of an affiliated interest as defined in section 707 accomplished by the issue, sale, acquisition, lease, exchange, distribution or transfer of voting securities or property. All REC reorganizations are subject to Public Utilities Commission approval and the Commission will only approve a reorganization if the applicant for approval can establish that the reorganization is consistent with the interests of the cooperative's ratepayers. In granting its approval, the Commission may impose terms, conditions or requirements which it deems necessary to protect the interests of ratepayers. Generally, the Commission will rule upon all requests for approval of a reorganization within 60 days of its filing with the Commission.

Although the Maine PUC does not have the authority to approve or disapprove the nature of a non-utility business, the Commission has the authority among other powers:

(1) to have reasonable access to books, records, documents and other information relating to the utility or its affiliates,
to have reasonable powers to detect, identify, review and approve or disapprove all transactions between affiliated interests,

(3) to assure that the ability of the utility to provide safe, reasonable and adequate service is not impaired, and

(4) to assure that reasonable limitations be imposed upon the total level of investment in non-utility business.

The Public Utilities Commission of Maine is a good example of a commission that has explicit statutory authority over the establishment of subsidiaries.

In New Mexico, REC (not RTC) diversification is regulated by New Mexico Public Service Commission's (NMPSC) Rule 450, entitled "Affiliate Transactions". There are two classes of transactions covered. The first, a "Class I transaction" is an affiliated transaction between a utility and its subsidiary. Any utility which enters into a Class I transaction should give written notification to the Commission within five days after the agreement, arrangement or amendment is entered into. Such notification should include:

(1) the terms of the arrangement, agreement, or amendment;

(2) a description of the goods, services, or other property interest to be provided to or by the utility;

(3) a discussion (including any studies or other pertinent information) of whether the utility could have attempted to obtain the goods or services at a price lower than that obtainable under the Class I transaction;

(4) if the utility is selling, leasing, or providing goods, services, or other property interests to an affiliate, a discussion (including any studies or other pertinent information) of whether the utility could have attempted to obtain a better price than under the Class I transaction; and

(5) a statement of the purpose of the transaction explaining how it benefits the utility or its ratepayers or both.

NMPSC Rule 450 also requires the filing of Class I Transaction Reports. Basically, this requires that any utility engaged in an affiliate transaction during the preceding six months must provide a statement showing the moneys or other items of value paid or transferred either by the utility to the affiliate or the affiliate.
to the utility. The statement must show the dollar amount of each affiliate transaction by account and by types of goods and services provided, the quantity, and the price paid and received.

The "Class II transaction" in New Mexico concerns the formation of a utility subsidiary. NMPSC Rule 450 states that no public utility may engage in a Class II transaction without first obtaining written approval of a general diversification plan from the Commission. The general diversification plan is very detailed and will not be discussed here. Commission approval of the general diversification plan is given only if the Commission finds that the level of investment involved in the transaction appears to be reasonable and that the utility's ability to provide adequate service at just and reasonable rates is not adversely affected by the transaction. NMPSC Rule 450 also lays out many additional requirements that the utility must meet to gain Commission approval. These will not be examined here.

In Ohio, the Ohio Public Utilities Commission does not regulate REC rates and only RTCs are covered by affiliated interest agreements. In an informal communication on November 17, 1988, Marsha P. Ryan, Director, Consumer Services Department, stated, "It is entirely up to the discretion of the Ohio PUC to decide whether a particular RTC diversification venture is within the jurisdiction of the Commission." She added that a decision is made after an in-depth examination of each request, however, there had never been requests by RTCs to diversify into areas such as CATV or TVRO sales and programming. Finally, Ryan believes that if such a request was made, the Commission would have powers to regulate areas such as financing, operations and maintenance under an affiliated interest agreement.

REC/RTC diversification is regulated in Texas by Article 1446c, entitled the "Public Utility Regulatory Act" (the Act), which defines affiliated interest or affiliate to include certain holding companies, affiliates, subsidiaries and persons or corporations actually exercising directly or indirectly, a substantial influence or control over the policies and actions of the utility. Section 67 of the Act provides the Texas PUC with jurisdiction over any affiliated transactions, between affiliated interests and jurisdictional utilities, to the extent of access to all accounts and records of the affiliated interest that relate to the transaction, including accounts and records of joint expenses applicable to the transaction.

The Texas PUC's Substantive Rules require that copies of contracts between any utility and any affiliated interest be filed with the Commission on request. In addition, all ownership and management relationships between companies or between companies and individuals, and all transactions with affiliates, including payments for interest expenses and the cost of any goods, services, property, or rights will be reported annually.
The Vermont Public Service Board (PSB) regulates the diversification of RECs (the state of Vermont has no RTCs) on a case-by-case basis. However, neither of Vermont's two RECs, Washington Electric Cooperative and Vermont Electric Cooperative, have ever requested the Vermont PSB to review an application for approval. In an informal communication on December 21, 1988, Michael Dworkin, General Counsel, Vermont PSB, stated that the PSB's jurisdiction in approving REC diversification is basically "unsolved", since it had not yet been encountered. He added, however, that if one of the RECs would make a request to diversify into a non-utility activity such as appliance sales and service, CATV or telecommunications equipment sales, he believed the Commission had the authority to enforce an affiliated interest agreement.

In West Virginia, REC/RTC diversification is regulated by Chapter 24 of the State Code of West Virginia, which states that no utility may by any means enter into a contract of service, property, or anything with an affiliated interest, unless West Virginia Public Service Commission approval is first obtained. It should be mentioned that some telephone services and products have been detariffed or deregulated such as CPE, inside wire, etc.

There are a variety of state statutes in Virginia that are applicable to regulating the diversification of RECs/RTCs. Chapter 4 of the Code of Virginia, entitled "Regulation of Relations with Affiliated Interests", states that no contract or arrangement providing for the furnishing of management, supervisory, construction, engineering, accounting, legal, financial, or similar services, and no contract or arrangement for the purchase, sale, lease or exchange of any property, right or thing, or for the purchase or sale of treasury bonds or treasury capital stock made or entered into between a public service company and any affiliated interest shall be valid or effective unless and until it shall have been filed with and approved by the Virginia State Corporation Commission. This again, is assurance that an affiliated company of a regulated utility does not receive unjust benefits, to the detriment of the utility's customers. Furthermore, Chapter 4 states that no public service company shall make, extend or renew any loan of money to any affiliated interest or assume, extend or renew any obligation or liability whatsoever of any affiliated interest, whether as guarantor, endorser, surety or otherwise, unless the Commission shall first have approved such loan or assumption, or the extension or renewal of such loan, obligation, or liability, as being not inconsistent with the public interest, and then only upon such terms and conditions as may be set forth in the order of the Commission approving such transaction.

Virginia statutes are unique in that they specify the types of non-utility businesses that RECs/RTCs may enter. For example, the "Distribution Cooperatives Act" in Chapter 9 of the Code of
Virginia allows RECs to engage in the distribution, servicing and maintenance of television reception, satellite dishes, encrypted television programs, and decryption equipment to its members. On the other hand, another law in Virginia specifically forbids RTCs from diversifying into non-telephone related areas.

As mentioned previously, Virginia is the only state in the SVL Survey that has applied its affiliated interest statute (Chapter 4) to actually review the diversification plan of a REC/RTC. Specifically, the Virginia State Corporation Commission reviewed Southside Electric Cooperative's (SEC) application for authority to guarantee Southside Communications Cooperative's (SCC) $3,000,000 loan with National Rural Utilities Cooperative Finance Corporation (CFC) and to provide management services to SCC, an affiliate. Pending Commission approval, SCC would join CFC as an associate member and would provide satellite dishes, decorders and receivers on a lease basis to its members, who are also members of SEC. On August 28, 1988, the Commission decided that approval of the application would not be detrimental to the public interest. For more details on this case, see Appendix A, which provides an Action Brief and an Order Granting Authority regarding this case.

Affiliated interest statutes combined with rate case examinations and management audits would create effective regulation of cooperatives and a forum to raise cross-subsidization and unfair competition issues.

Antitrust Legislation and FTC Jurisdiction

As previously mentioned, cooperatives have very few limitations on their ability to diversify into non-utility activities. The major obstacle to diversification is based on the desire to ensure that a cooperative's non-utility business does not disrupt customer service and cause unreasonable rate increases. Evidence suggests that state regulatory commissions are much more concerned with the cost of service to customers than with unfair competition in non-utility business. It is the role of the state commission to possibly impose accounting procedures to ensure that ratepayers are not required to support non-utility activities that do not contribute directly to the delivery of secure electric or telephone service. Most state commissions, however, do not have the legal authority to hear cases involving antitrust issues that do not impact ratepayers, since they have not been granted such power by state legislatures.

Some state commissions have explicitly stated that their authority does not include protecting a utility's competitors. For example, in a proceeding before the New York Public Service Commission considering a request by the Long Island Lighting Company for permission to establish a new subsidiary, the Commission refused to consider evidence concerning the competitive impact of the new activity. LILCO Energy Systems Inc., Case No. III-62
28025 (Commission Order of January 13, 1982). Also, In March 1985, the Georgia Public Service Commission responded to a complaint concerning the marketing practices of the Atlanta Gas Light Company in selling gas appliances by stating that the Commission had no jurisdiction over the utility's non-utility operations.¹

Anti-competitive practices such as price fixing, predatory pricing, price discrimination and any other actions that have an adverse effect upon competition are all forbidden by language contained in the Clayton Act, Sherman Act and Federal Trade Commission Act. For example, sections 1 and 2 of the Sherman Act prohibit monopolization and attempts to monopolize as well as "conspiracies in restraint of trade" (price fixing). Also, sections 2 and 3 of the Clayton Act outlaw price discrimination practices as well as exclusive and tying contracts. Finally, section 5 of the Federal Trade Commission Act forbids "unfair methods of competition, in or affecting commerce." This includes acts forbidden by the Sherman and Clayton Antitrust Acts, as well as other actions that do not violate those statutes but that nonetheless give the utility the ability to foreclose competition in the markets in which it operates.² The Federal Trade Commission (FTC) is given the authority to prevent practices that are forbidden by the above legislation.

The Federal Trade Commission Act empowers the FTC not only to halt specific antitrust violations, but to prohibit potential violations - those activities which are likely to result in a violation if allowed to proceed. In order to determine if a business activity has the potential for violating antitrust laws, the FTC "is empowered to make expert business judgements about the probable consequences of certain activities, and to prohibit those likely to result in future antitrust violations."³ To summarize, the FTC has jurisdiction to investigate and prevent unfair methods of competition by regulated utilities in non-utility businesses. Naturally, this authority applies to rural electric and rural telephone cooperatives.

In practice, antitrust cases have seldom been brought against utilities, especially cooperatives, for attempting to monopolize in non-utility businesses.


The huge cost of bringing an antitrust case to court is one major obstacle facing small businesses who feel they are at a severe disadvantage against utilities. In most cases, businesses that organize themselves into trade associations may be able to overcome this problem.

Another major obstacle facing utility competitors is that it may be very difficult to prove that they have been shut out of the market. This is especially true in the energy services and products market, which is considered to have very low barriers to entry.

Proving an antitrust violation in federal court requires the complainant to demonstrate that a utility is illegally subsidizing products so as to sell them below cost and that there is either an intent to drive the small business from the market or that the effect is to drive them from the market.

A final obstacle in applying the antitrust laws deals with the "state action defense." Basically, a utility may be able to defend its entrance into non-utility businesses if it can prove that a state regulatory commission, under the authority of a state statute, affirmatively orders and actively supervises a cross-subsidy.

As opposed to filing an antitrust case in federal court, complaints may also be filed with the FTC. If the FTC believes that cross-subsidies do indeed exist, it has basically two options available. The first course of action is an antitrust enforcement proceeding where there is evidence of attempts to monopolize and predatory pricing by a utility. This approach, however, requires the FTC to "prove that cross-subsidization not only exists, but is occurring to a sufficient degree to enable the utility to price below its costs in the (unregulated) market." In addition, the FTC must overcome the aforementioned "state action defense" obstacle and prove that the non-utility business of the utility is characterized by substantial barriers to entry. Due to these legal issues as well as the large volume and complexity of the accounting data maintained by utilities, the FTC faces a giant task in determining whether cross-subsidization is illegal in a specific case. In summary, "federal antitrust laws generally will not apply

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to the cross-subsidization problem (without the presence of other anticompetitive behavior)."  

There is another option open to the FTC when it deals with cross-subsidies. This occurs during situations in which a cross-subsidy or other anticompetitive situation exists, but the utility's behavior does not constitute an antitrust violation. Under this approach, the FTC might intervene in a ratemaking proceeding before a state regulatory commission and point out the harm to competition, consumers and small business that could result from allowing a cross-subsidy to occur. Additionally, the FTC could appear before Congress or a state legislature to call attention to practices that may injure competition and consumers.

BIBLIOGRAPHY


SURVEYS THAT SUMMARIZE THE REGULATION OF RECs/RTCs

Survey 1

In December 1987, a survey was conducted by SVL Associates in which questionnaires were distributed to 50 state and the District of Columbia Public Utility Commissions. The major objectives of this survey (Appendix B) are:

1. To identify the states which have regulatory power over utility operations of rural electric and telephone cooperatives (RECs/RTCs).

2. To identify the states which regulate the diversification activities of RECs/RTCs into non-utility businesses.

3. To identify the complaints and/or legal proceedings brought by small businesses against RECs/RTCs concerning cross-subsidization and/or unfair competition.

Of the 51 responses, there are no rural electric cooperatives operating in Connecticut, the District of Columbia, Hawaii, Massachusetts, and Rhode Island. Of the remaining 46 respondents, 18 (39%) stated that their organization had the authority to regulate the rates of RECs.

Many of the respondents qualified the extent of their regulatory powers over RECs. Not all regulatory bodies have the authority to control rates, financing and service areas. For example, while the Georgia Public Service Commission does not have the power to regulate rates, they have been given the authority to regulate service areas and approve financing. Likewise, the Iowa State Commerce Commission and the Mississippi Public Service Commission regulate services and service areas only.

There are no rural telephone cooperatives operating in California, Connecticut, Delaware, the District of Columbia, Florida, Hawaii, Maine, Maryland, Massachusetts, New Jersey, New York, Rhode Island and Vermont. Of the remaining 38 respondents, 21 stated that they had the authority to regulate the rates of RTCs.

Again, many of the respondents qualified the extent of their regulatory authority over RTCs. For instance, the Iowa and Nevada Commissions regulate only services and service areas and the Wyoming Public Service Commission regulates all RTCs with the exception of farmers' mutual telephone cooperatives giving toll-free service to members.

Most of the commissions that do not regulate RECs/RTCs did not identify any other regulatory body. One "regulatory body" that was mentioned by California is the local court, which hears cases
involving rate and territory disputes. Likewise, the TVA and the New York Power Authority are responsible for regulating rates in Tennessee and New York, respectively.

Based on the SVL survey and telephone follow-up calls, it was determined that the diversification of RECs/RTCs is regulated in only 7 states: namely Maine, New Mexico, Ohio, Texas, Vermont, Virginia and West Virginia. A discussion of exactly how the diversification ventures of RECs/RTCs are regulated can be found in Section III. E, State Commission Authority.

Finally, although some of the respondents to the survey reported complaints and/or legal proceedings brought by small business against various utilities, there were no reports of complaints against RECs/RTCs.

Survey 2

In June 1985, Robert Gibson researched the 46 states where rural electric systems operate. This survey (Appendix C) looks at the regulation of RECs in three areas: rates, financing and service area. In 26 of those 46 states, the state accepts the self-regulation of the cooperative membership as the best way to assure fair rates. In the other 20 states, self-regulation is not considered sufficient protection for consumers.

Of the 46 states, rates are regulated in 20 states, and financing practices are regulated in 14 (30%) states. However, there seems to be a trend towards less regulation occurring at the time this survey was conducted. Specifically, states such as Alaska and Colorado are allowing the cooperative membership to vote on whether or not they wish to be regulated. 18 of Colorado’s 22 rural electric systems have chosen deregulation. Similarly, a rural electric system in Alaska can become deregulated upon the vote of 15 percent of its members. Finally, some states (Michigan) are developing a rate-making mechanism whereby cooperative rates are automatically raised or lowered when triggered by changes in the cooperative’s Tier level.

In most of the states, REC service areas are protected. Territorial protection for cooperatives has steadily improved during the past decade, at least on paper. Now, only five states - Delaware, Florida, New York, Washington and West Virginia - do not protect cooperative service areas from the intrusion of neighboring utilities. However, in many states, the cooperative territory is not protected from municipal annexation or aggressive investor-owned companies, and this is a source of complicated and

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1 Published in Rural Electrification Magazine, July 1985, pp. 8-16.
damaging territorial disputes in state after state. In Colorado, for example, municipal annexation of territories all along the eastern slope of the Rocky Mountains formerly served by cooperatives severed the growth of the cooperatives. Also, in Florida, prolonged and costly territorial disputes between cooperatives and investor-owned companies have gone before the state's Public Service Commission.

Survey 3

In 1985, the National Association of Regulatory Commissioners (NARUC) published a list of the agencies that have the authority to regulate rates. The results of Survey 3 (Appendix D) depict in greater detail the regulation of rates for electric, gas and telephone utilities. There were 66 respondents to this survey in which electric utilities were classified as private, public, or cooperative systems. Thirteen of the respondents are not regulatory agencies in the United States. Therefore, the study is comprised of 53 respondents which include the Federal Communication Commission (FCC), Federal Energy Regulatory Commission (FERC) and agencies from the District of Columbia and each U.S. state.

On sales to ultimate consumers, cooperative rates are regulated or controlled by 25 of the 53 respondents. Additionally, 23 agencies have the authority to regulate or control rates on sales to public authorities for public use (not for resale) and sales to the U.S. Government (not for resale). 20 of the respondents indicated that they have the authority to require prior authorization of rate changes.

Summary

The aforementioned SVL survey concluded that 21 state regulatory commissions had the authority to regulate the rates of RTCs and only 18 commissions had the authority to regulate the rates of RECs. Furthermore, this same survey determined that only 7 state regulatory commissions had the authority to regulate REC/RTC diversification through affiliates or subsidiaries. When these responses are compiled, it can be concluded that only the commissions of Maine, Texas, Vermont and Virginia have full jurisdiction (authority to regulate both REC/RTC rates and diversification) over all the RECs/RTCs in their state. The New Mexico PSC has full jurisdiction over RECs only and the Ohio PUC has full jurisdiction over RTCs only.

It is clear that the best means for state regulators to detect cross-subsidization and therefore protect the ratepayer is to

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utilize as many regulatory tools as possible. However, as mentioned earlier, cost considerations will always hamper state regulators. It seems then, that regulating REC/RTC rates and utilizing affiliated interests statutes is the best method available to state regulatory commissions to protect both the ratepayer and small businessman. But, as mentioned above, few states currently have this type of regulation.

Anti-competitive practices such as predatory pricing, price fixing, price discrimination and any other actions that have an adverse effect upon competition are all forbidden by language contained in the Clayton Act, Sherman Act and Federal Trade Commission Act. Cross-subsidization could be carried out to the extent that the utility may set its price in the unregulated market below its actual costs to drive its competitors from the market and then raise its price to obtain monopoly profits. This conduct would constitute a violation of the Sherman Act and could form the basis for an FTC challenge to the cooperatives.
TO: CHAIRMAN PRESTON C. SHANNON
COMMISSIONER THOMAS P. HARWOOD, JR.
COMMISSIONER ELIZABETH B. LACY

RE: Southside Electric Cooperative's ("SEC") application for authority to guarantee Southside Communications Cooperative's ("SCC") $3,000,000 loan with National Rural Utilities Cooperative Finance Corporation ("CFC") and to provide management services to SCC, an affiliate.

BACKGROUND:

During the 1987 legislative session, the Code of Virginia, Section 56-2.10 was amended so that rural electric cooperatives could provide certain communication services to its members. Pursuant to this amendment, SEC has initiated the forming of Southside Communications Cooperative and a charter for that cooperative has been issued by the Commission. The new cooperative will provide satellite dishes, decoders, and receivers on a lease basis to its members, plus a member option package of programs provided through the National Rural Telecommunications Cooperative. During 1987, SEC surveyed its members and of the 7,929 surveys returned, 73 percent of those indicated a desire for SEC to assist in providing quality television reception.

SEC has conducted surveys and has contacted other cooperatives as well as the National Rural Telecommunications Cooperative in order to determine the feasibility of providing the above described services. SEC estimated that the number of satellite receiving units being installed would range from 25 to 50 per month. SEC's Board established a figure of 35 units per month as being the estimated base for the new cooperative, with 20 percent of those installations being for decoders only. The survey revealed that 554 people already owned satellite dishes.
A financial analysis program was provided by CFC, the banker for this venture. The evaluation estimates reflect a cost of equipment not to exceed $3 million over the first three years of operation. Program rental costs, plus deposits on the receiving units will net a profit in 1991, as estimated by the financial analysis computer package provided by CFC. The purchase of stock by SEC will provide the funds for the start-up and operational costs until the first units are installed and on the normal billing cycle. SEC estimates that the monthly billing will cover operational and installation costs for additional units as they are installed, (plus provide the loan payment and interest expense.)

PROPOSAL:

Southside Electric Cooperative proposes to guarantee Southside Communications Cooperative's loan with CFC (PUA880035) and to provide management services to SCC (PUA880036).

Terms of the CFC Loan

Southside Electric Cooperative will guarantee the payments due under a loan agreement between SCC and CFC. SCC is eligible for the Associate Member Intermediate-Term and Variable Rate Long-Term loan programs. The term of the loan is for a seven year period. Under this type of loan program, the funds are a separate pool of CFC funds. The interest rate of 7.125% per annum reflects the cost of CFC funds, the value of Associate Member equity investments in CFC, plus adders for CFC's margins and administrative costs. The interest rate is subject to change monthly.

Present calculations indicate that SCC will need a maximum of approximately three million dollars within the next two and a half years to fund the new project. The monthly member payments for the communication services are expected to cover the operational costs as well as the debt service cost. However, in the event SCC defaults on its interest payment to CFC, then SEC under the guarantee would have to make the payments.

Terms of the Stock Issuance

Under the laws of Virginia for cooperatives other than electric cooperatives, the new cooperative must be a stock company. Southside Communications Cooperative will be established with 1,000 shares of common stock with a par value of $25.00 per share. SEC will own all of the outstanding shares of SCC and will maintain control of SCC until such time as all debts guaranteed by SEC have been paid by SCC and the stock repurchased by SCC. SEC's equity investment will assist SCC in start-up costs and maintain control of the new cooperative until it becomes profitable to the point of a stand-alone cooperative.
Terms of the Affiliates Agreement

Currently SCC does not maintain any full time employees or business equipment. SEC will be an exclusive agent for the management of the telecommunications cooperative. The type of services to be provided under this agreement include the following: accounting services, collections and billing, preparation of financial reports, provision of maintenance or entry into contracts for maintenance and repair beyond SEC's capabilities, and office and warehouse rental.

SCC will pay SEC the actual wages and overhead for the labor force used by SEC to perform work for SCC. SCC will only be able to service SEC members, therefore, an addition to the bill already provided to SEC members will be made if they elect to join SCC. For billing purposes, the computer will allocate payments to SCC first and the balance to SEC. The total amount collected for SCC will be deposited into a separate bank account obtained by SCC. SEC states the actual additional expense of the billing will be nominal.

Service requests from SCC members will be handled by the standard SEC service request procedure for new service and a security light will be added to member accounts. The data for each SEC member account is computerized, therefore the addition of the SCC service is a simple process.

Operations and maintenance are exact cost items and will be paid to SEC by SCC direct from a time sheet detailing employee wage rates and the amount of time spent providing the service. Also, advertising and marketing will be a direct SCC paid expense and will not affect SEC.

The following direct payments will be made by SCC: payments to National Rural Telecommunications Cooperative, payments to CFC, equipment purchase payments, member refunds, deposit refund plus interest, membership fees in associated organizations, quarterly billings from SEC, interest on late payments to SEC, state/federal and corporate taxes, and all payments not specifically listed in the management agreement with SEC.

Southside Electric Cooperative states in its application that the concept is for it to completely operate SCC. The Bylaws of SCC state that two members of SEC's Board and the Executive Vice President of SEC will serve on the Board of the new cooperative, along with two members elected at large.

DISCUSSION:

SEC states that SCC will provide a much needed service to members for it has several service areas that do not receive quality television reception, especially in Brunswick County and...
the area west of Altavista. SEC serves less than six members per mile and under the present criteria for cable television the service must be in excess of 25 members per mile.

Upon review of the application, it appears that the current members of Southside Electric Cooperative support the proposed services which will be provided by Southside Communications Cooperative. The financial analysis done by SEC has been reviewed by the Staff. The assumptions appear reasonable for a positive cash margin by 1989 and an overall profit by 1991. However, the Staff must also take into consideration the loan guarantee by SEC. If SCC is not profitable and is unable to service its debt, then SEC will be responsible for the debt and it will assume the assets of SCC. In order to ensure that the loan guarantee does not affect the regulated operations of SEC, the Staff recommends that any future payments of debt service made by SEC or the assumption of the CFC loan will not be recovered in any future rate proceeding. All risk associated with the unregulated telecommunications service must not affect the regulated cooperative.

Staff supports the intent of SCC's venture into providing quality television reception for SEC members and recommends approval of the application as filed. A yearly status report from SEC on the operating and financial condition of SCC is recommended to be filed with the Commission as long as SEC has controlling interest in the new cooperative and is guarantor of the CFC loan.

Virginia J. Ginn
Senior Utility Securities Analyst

Ronald A. Gibson
Director

VJG/RAG/dmc
APPLICATION OF
SOUTHSIDE ELECTRIC
COOPERATIVE

For authority to guarantee
a loan and to enter into a
management agreement with
an affiliate

ORDER GRANTING AUTHORITY

Southside Electric Cooperative ("SEC", "Applicant") has
filed an application under the Public Utilities Securities Law
and the Public Utilities Affiliates Law requesting authority to
guarantee Southside Communications Cooperative's ("SCC") loan
with the National Rural Utilities Cooperative Finance Corporation
("CFC") in the amount of $3,000,000, and further requests
authority to enter into a management service agreement with SEC.
Applicant has paid the requisite fee of $250.

SEC proposes to guarantee the loan of Southside
Communications Cooperative, an affiliate, in the amount of
$3,000,000. In the event SCC should default on its loan
obligation, SEC will assume the debt obligation as well as the
assets of SCC. SCC is obtaining the loan from CFC for the
purpose of operating business as a telecommunications
cooperative. SCC will provide satellite dishes, decoders, and
receivers on a lease basis to its members, plus an option package
of programs provided through the National Rural Telecommuni-
cations Cooperative with which it will be associated.
Southside Electric Cooperative will maintain control over the new telecommunications cooperative through ownership of SCC's common stock. All outstanding common stock of SCC will be owned by SEC, such stock will have a par value of $25.00 per share. SEC's investment will equal $25,000 and will provide SCC funds for start-up costs associated with the new venture.

Southside Electric Cooperative also proposes to enter into a management service agreement with Southside Communications Cooperative. The types of services which will be provided under the agreement include: accounting, financial reporting, billing and collections, maintenance and repair, and customer service. Applicant states that the addition of the telecommunications service to its current members' bills will be a simple procedure since its data base is already computerized. Applicant states that the actual additional expense of billing is nominal, but for the protection of Applicant a billing cost was formulated based upon time estimates to actually establish the billing system for SCC. All money received from SCC members will be deposited into a separate bank account of SCC.

THE COMMISSION, upon consideration of the application and representations of the Applicant and having been advised by its Staff, is of the opinion that approval of the application will not be detrimental to the public interest. Accordingly,

IT IS ORDERED:

(1) That Applicant is authorized to guarantee the CFC loan of Southside Communications Cooperative in the amount of $3,000,000, for the purpose and under the terms and conditions as
stated in the application;

(2) That Applicant is authorized to participate in the management agreement with SCC for the purposes and under the terms and conditions as stated in the application;

(3) That in the event SCC defaults on its debt obligation to CFC, Applicant shall assume the debt obligation as its own and further assume all of SCC's assets; however, the debt obligation or any service thereunder shall not be included in any rate proceedings brought before this Commission on behalf of Applicant;

(4) That the authority granted herein shall not preclude the Commission from applying the provisions of Sections 56-78 and 56-80 of the Code of Virginia hereafter;

(5) That in the event the terms or conditions of the agreement described in the application change, then the authority granted herein shall be voided;

(6) That Applicant file a report on an annual basis detailing the operational and financial condition of Southside Communications Cooperative, such report shall be filed as long as Applicant is guarantor of SCC's loan with CFC;

(7) That the aforementioned report shall be filed with the Director of Accounting and Finance of the Commission on or before April 1, 1989, for the preceding calendar year, and each subsequent year thereafter; and

(8) That there appearing nothing further to be done in this case, the same be, and it hereby is, dismissed.
AN ATTESTED COPY hereof shall be sent to Applicant, attention of Mr. John C. Anderson, Executive Vice President, Post Office Box 7, Crewe, Virginia 23930; and to the Director of Accounting and Finance of the Commission.
# Regulation of Rural Electric Cooperatives (RECs) and Rural Telephone Cooperatives (RTCs)

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<th>State</th>
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ABBREVIATIONS

- BPU: Board of Public Utilities
- CC: Corporation Commission
- CCM: Commerce Commission
- DPC: Department of Public Utilities
- PUC: Public Utilities Commission
- PUCon: Public Utility Control
- PSB: Public Service Board
- PSC: Public Service Commission
- SCC: State Commerce Commission
- UC: Utilities Commission
- URC: Utility Regulatory Commission
- UTC: Utilities and Transportation Commission
Notes:

1. Regulation of California PUC does not extend to rates, borrowing on indebtedness or property disposal. Other aspects of REC activity are subject to California PUC's jurisdiction and REC's tariffs are maintained at California PUC.

2. There are no RTCs operating in this state.

3. Disputes involving either rates or charges of RECs are usually handled in court.

4. In Florida, RECs are regulated on rate design-territorial disputes and safety. Rates of RECs are not regulated.

5. This state regulates service areas and approves financing, but does not regulate rates.

6. Regulation of services and service areas only.

7. There are no RECs operating in this state.

8. Tested on a case-by-case basis in rate cases only when issue of cross-subsidization is raised by intervening party.

9. This state does not regulate rates but does regulate service areas.

10. In Ohio, RECs are organized into a state association of rural electric cooperatives. Also, certified territories of RECs are within the Ohio PUC's jurisdiction. Rates are not regulated.

11. The Texas PUC has no formal jurisdiction over the diversification decisions of the utilities it regulates. However, the Commission does have jurisdiction over the bookkeeping.

12. The Commission's approval must be sought for contracts among utilities and their affiliates. At the same time, some areas (e.g. telephone services and products) have been deregulated. New accounting procedures are being prescribed for the deregulated areas.

13. RTCs are regulated with the exception of farmers' mutual telephone cooperatives giving toll-free service to members.

14. The respondents to this survey did not identify any complaints and/or legal proceedings in their state brought by small business against RECs/RTCs concerning cross-subsidization and/or unfair competition. This may be because the majority of states do not regulate the rates of cooperatives. (There are 18 state commissions that regulate the rates of RECs, 21 state commissions that regulate the rates of RTCs and 7 commissions that regulate REC/RTC diversification.)
APPENDIX C
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### Notes:

1. TVA exercises limited regulation over 52 rural electric systems in Alabama (8), Georgia (3), Kentucky (4), Mississippi (11), Tennessee (24) and Virginia (1).

2. The cooperative territory is not protected from municipal annexation or aggressive investor-owned utilities.

3. However, a system can become deregulated upon the vote of 15 percent of its members. In Alaska, three systems have elected deregulation since 1980.

4. However, RECs are allowed to become deregulated by a vote of the membership. 18 of the 22 systems in Colorado have elected deregulation.

5. Only for the cooperatives whose rates are still regulated.

6. Regulation for rate design only, not rate levels.

7. Territorial disputes may be brought before the Florida PSC for a hearing.

8. Not directly, though neighboring utilities may negotiate boundary agreements and submit those agreements to the Illinois CCM.

9. However, as of December 31, 1983, cooperatives can vote to become regulated, and so far 4 of the 13 systems have done so.

10. Only for RECs serving 1,000 or more consumers.

11. Through commission rules that employ a "closer to" principle to avoid duplication of service.

12. In Michigan, a cooperative's rates are automatically raised or lowered when triggered by an increase or a decrease in its TIER level.
13. In Minnesota, cooperatives can be regulated by a vote of the cooperative membership, and so far 2 of 48 systems have done so.

14. In Nebraska, territorial protection is overseen by the Power Review Board.

15. In Tennessee, rates are overseen by TVA.
### TABLE 3 - REGULATION OF RATES: ELECTRIC, GAS AND TELEPHONE UTILITIES

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NARUC Annual Report on Utility and Carrier Regulation 1985
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**TABLE 3 - REGULATION OF RATES: ELECTRIC, GAS AND TELEPHONE UTILITIES**

NARUC Annual Report on Utility and Carrier Regulation 1985
FOOTNOTES - TABLE 3
REGULATION OF RATES: ELECTRIC, GAS AND TELEPHONE UTILITIES

1/ The FERC has statutory jurisdiction over the power and transmission rates of the Bonneville Power Administration and jurisdiction over power and transmission rates of DOE's other power marketing agencies as delegated by the Secretary of Energy. Rates for the transmission of non-Federal electric power over the Federal Columbia River Transmission System became effective upon confirmation and approval by FERC under the Federal Columbia River Transmission System Act.
2/ Publicly owned utilities are regulated as to service area. Full regulation is imposed when competition exists between municipal and similar utility.
3/ Public utilities regulated when outside of municipal boundary only.
4/ Same as for private utilities and co-ops for facilities outside of 3 miles from the corporate limits of municipalities. Commission has no jurisdiction within the 3 mile limit.
5/ Only if earnings exceed 8 percent of original cost of plant in service or if discrimination between class of customers.
6/ Municipal utilities exempt from State regulation.
7/ Authority limited in individual cases by legislation or court decision.
8/ Municipally owned utilities are fully regulated with respect to service beyond five miles of municipal boundary.
9/ Not over publicly owned electric utilities served by NYS Power Authority. Publicly owned gas or electric utilities need not decrease rates unless investigation was based upon complaint of 25 or more active customers.
10/ No natural gas in Puerto Rico.
11/ Only when service extends beyond the corporate limits of a publicly owned utility company.
12/ None in state.
13/ Seven months after filing, utility may place a portion of the increase in effect not to exceed 15% of their gross interstate operating revenue.
14/ Not unless co-op extends activities to include functions that make it a public utility under the statutes except to portion of co-op service within incorporated municipality as a result of annexation.
15/ Plus 60 days notice.
16/ Authority to regulate rates for interstate and foreign services of telephone and telegraph carriers.
17/ FERC reviews rates by interstate pipelines to mainline industrial customers in certificate proceedings.
18/ Authority not exercised.
19/ The Puerto Rico Telephone Authority, a state public corporation created by Law 25 (May 6, 1974) purchased the Puerto Rico Telephone Company.
20/ Commission jurisdiction excluded from rates covered by special agreements with municipalities.
21/ Jurisdiction over all rates either by tariff or contract.
22/ Commission jurisdiction excluded from rates for intrastate service covered by special agreements with municipalities and rates for interstate services subject to the Federal Energy Regulatory Commission.
23/ Authority limited to rate charged and manner of delivery.
24/ Primarily Federal Energy Regulatory Commission jurisdiction.
25/ No specific statutory authority.
26/ May fix temporary rates, but practice is not followed.
27/ Interim rates must be approved and are collected under bond subject to refund.
28/ Commission has authority to grant partial and immediate rate relief during pendency of final order, after statutory requirements are met.
29/ May permit rates to go into effect, subject to refund.
30/ Interim rates may be prescribed after a hearing.
31/ Required to advertise 30 days prior to change.
32/ Rates for interstate service subject to FERC.
33/ When not subject to FERC.
34/ Specific authority required to change rates. Rates do not become effective after a specified period, consequently, no suspension is required.
35/ Mutual telephone companies in which at least 50% of the users are owners, cooperative telephone corporations or associations, and telephone companies having less than 15,000 customers and less than 15,000 access lines are not subject to rate regulation.
36/ Hawaii law provides that rate increases may not go into effect until approved by the Commission.
37/ Effective July 1, 1978 for electric and gas private utilities. Effective July 1, 1982 for telephone utilities.
38/ Emergency only.
39/ 60 days at a time; up to a total of 6 months.
40/ Can investigate co-op rates for discriminatory practices.
41/ Except no authority over rates charged to industrial customers by any gas company.
42/ Telephone is the only regulated utility. Electric service is supplied by political subdivisions called public power districts, electric cooperatives and municipal electric systems. Nebraska is unique among the states in having no private power companies; all electric facilities are publicly-owned or member-owned. Natural gas is provided by private companies through franchise granted by each city, town or village.
43/ Basic rate structure regulation only.
44/ Rates for interstate sales are subject to the jurisdiction of the FERC; intrastate rates are subject to State regulation.
45/ Public utilities regulated insofar as they are owned and operated outside corporate limits.
46/ Municipals can put rates into effect after 45 days. The Board can order an investigation and rates may be subject to rebate.
47/ The Commission may extend the ten-month suspension period for periods of time and for reasons established by statute.

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If municipality, appellate jurisdiction only. This Commission has original jurisdiction over two public authorities (River Authority).

Wyoming Supreme Court decision to effect PSC cannot regulate gas sale for resale.

To extent not Federally preempted.

Only if authorized by Lieutenant Governor in Council.

Alberta PSC may determine what amounts are eligible for inclusion in cost of service.

If for resale outside municipal boundaries. Pursuant to the Electric Energy Marketing Act the Alberta PUB has jurisdiction to fix the price at which one publicly (municipal) owned utility sells to the Alberta Electric Energy Marketing Agency.

Only if the municipality has passed a by-law approved by the Lieutenant Governor in Council, bringing itself under the Alberta PUB or if the public body is the Government of the Province of Alberta.

Rates must be filed 30 days before final adoption by the utility; however, the rates become effective regardless of whether the PSC issues a comment to the utility on some aspect of its rate structure.

Has authority only at the election of the cooperative.

Rates cannot be increased without hearings and a subsequent order of the Commission, consequently, no suspension is required.

PUC does not regulate rates of rural telephone cooperatives or of thirteen independents and three municipalities.

Commission has limited review authority over rate changes by municipally owned utilities.

One hundred and fifty days beyond automatic 35 days and two additional days for each day of hearings on merit beyond 15 days.

One year for utilities with $3 million or less annual gross revenues; indefinite for utilities with over $3 million in annual gross revenues. Interim rates must be acted upon within five months for utilities with $3 million or less annual gross revenues; no statutory requirements for large utilities.

Rates become effective after seven months if Commission does not take action.

May be extended to nine months if just cause is shown in the Record.

Only that service which extends one mile beyond the corporate limits.

Rates of cooperatives providing services to members only are not regulated.

May become deregulated upon majority vote of at least 15 percent of eligible members.

Only intrastate WATS.

Rates are not regulated for gas utilities serving fewer than 650 customers.

PSC has state authority to require investor-owned, municipal and cooperative utilities to wheel. PSC is preempted by FERC from setting wheeling rates for investor-owned utilities, but may regulate wheeling rates for municipal and cooperative utilities.

Investor-owned gas distribution companies only.

Commission's alternate energy production rules, adopted pursuant to Iowa Code Sec. 476.43, set wheeling rates.

Five local exchange companies must receive approval prior to changing rates; all other 89 companies must give notice but do not need PUC approval.

The Commission has authority to regulate rates for certificated interexchange carriers but allows these rates to be set competitively.
IV. COMPETITION BETWEEN SMALL BUSINESS
AND RURAL ELECTRIC (RECs) AND TELEPHONE COOPERATIVES (RTCs)
IN NON-UTILITY BUSINESSES
IV. A. POTENTIAL UNFAIR COMPETITION
POTENTIAL UNFAIR COMPETITION

This section will consider the potential unfair competition issues relating to rural electric and rural telephone cooperatives (RECs and RTCs) into non-utility businesses. The focus here is on the effects of this diversification on both ratepayers and small business competitors. Several key cases are included in Section B of this chapter.

This section is divided into eight parts:

1. **Surveys of Cooperatives, the National LP-Gas Association (NLPGA) Members and the National Electrical Contractors Association (NECA) Members:**

   1.1 **Survey of Cooperatives With Non-Utility Business Involvement:** This part presents the results of a survey performed by SVL in 1988 concerning the diversification of cooperatives into non-utility businesses.

   1.2 **Survey of National LP-Gas Association (NLPGA) Members:** This part presents the results of a survey performed by SVL and NLPGA in 1988 to evaluate the potential competition between cooperatives and NLPGA members.

   1.3 **Survey of the National Electrical Contractors Association (NECA) Members:** This part presents the results of a survey performed by Enviro-Management & Research, Inc. and an SVL telephone survey in 1988 to evaluate the potential competition between cooperatives and NECA members.

2. **Economic Issues:** This part discusses the economic issues raised when utility cooperatives diversify into non-utility businesses.

3. **Financing:** This part discusses the financing advantages which cooperatives can bring to their diversified ventures.

4. **Marketing:** This part presents the marketing advantages which cooperatives can bring to their diversified ventures.

5. **Operations:** This part presents the advantages in the area of operations which cooperatives can bring to their diversified ventures.

6. **Special Tax Treatments:** This part discusses the tax exempt status of cooperatives, one of the major advantages of RECs and RTCs.
7. **Cross-Subsidization and Potential Unfair Competition**: This part discusses the issues of cross-subsidization and the potential unfair competition which may require the attention of the Federal Trade Commission and state legislatures.

8. **Conclusion**: This part presents the summary and conclusions.

1. **SURVEYS OF COOPERATIVES, NLPGA MEMBERS AND NECA MEMBERS**

Rural electric/telephone cooperatives across the country have in recent years, entered into a wide range of businesses. Many independent businesses claimed that RECs/RTCs, through diversified activities, have engaged in unfair and anticompetitive practices which can threaten the financial livelihood of the truly independent business.

In order to obtain data associated with the diversified activities of RECs/RTCs and the nature of competition between cooperatives and independent business, the following surveys were conducted:

* Survey of Cooperatives With Non-utility Business Involvement (Performed by SVL)

* Survey of the National LP-Gas Association (NLPGA) Members (Performed by SVL and NLPGA)

* Survey of the National Electrical Contractors Association (NECA) Members (Performed by Enviro-Management & Research, Inc. and SVL)

The results of these surveys are discussed in the following sections.

1.1 **Survey of Cooperatives With Non-Utility Business Involvement**

In order to further our study of rural electric and telephone cooperative involvement in non-utility business ventures, SVL Associates conducted a survey of these cooperatives during the summer of 1988. The results of this survey are presented in Appendix A. A total of 1,170 survey questionnaires were mailed, 922 to RECs and 248 to RTCs. Responses received from RECs totaled 344, for a response rate of 37.3 percent. The response rate of the RTCs surveyed was 37.1 percent, with 92 surveys returned. Overall, responses received totaled 436, for a response rate of 37.3 percent. In a memorandum, the National Rural Electric Cooperative Association (NRECA) General Manager, Mr. Bob Bergland, advised the NRECA member-systems regarding the content of the SVL Survey and indicated that completion of the SVL Survey would not help the
promotional effort in the area of rural economic development. Therefore, it is not unlikely that many diversified electric cooperatives did not respond to this survey.

To the question of whether their organizations own any "non-utility" businesses besides providing traditional utility services, 15 RECs, or 4.4 percent of those responding, answered yes. Among the RTCs, 22 of the respondents, or 23.9 percent, answered this question in the affirmative. Those cooperatives acknowledging involvement in such businesses totaled 8.5 percent of all responses received. This may well be an underestimate of the percentage of rural utility cooperatives involved in non-utility businesses, however, since responses to the survey were made on a purely voluntary basis. Rural electric and telephone cooperatives are diversifying into a number of different businesses such as natural gas marketing & sales, satellite TV programming, satellite dishes & equipment, cable TV, customer premises equipment, Radio Shack, 2-way radio, telephone business systems, computer stores, cellular phones, and appliance sales and services.

Over one-half of the respondents owning non-utility businesses identified these businesses as being related to rural, cable, or satellite television. Also, 30 percent of the respondents involved in non-utility businesses listed these ventures as having been organized in 1988. This appears to suggest that involvement in such activities is becoming increasingly popular although only 7 of the 37 respondents with non-utility businesses said they planned further diversification, mostly telecommunications-related.

Among the 24 cooperative respondents with non-utility ventures who voluntarily provided us with revenue figures for 1987, the cooperatives' non-utility businesses had revenues equal, on average, to 8.77 percent of their utility revenues. The range of percentages observed was great, however, with non-utility revenues as low as .03 percent and as high as 45.67 percent of utility revenues reported.

For 1986, only 18 respondents with non-utility businesses provided us with revenue figures. Of these, the non-utility business provided revenues equal, on average, to 8.27 percent of utility revenues. The responses ranged from a low of .19 percent to a high of 39.32 percent of utility revenues.

During both years, the rural telephone cooperatives' non-utility ventures achieved higher revenues relative to utility revenues than the rural electric cooperatives' diversified businesses did. For 1987, the 5 RECs responding showed non-utility revenues at an average of 2.34 percent of utility revenues. Among the 19 RTCs responding this average was 10.46 percent. For 1986, the averages were 2.77 percent among the 4 RECs responding and 9.84 percent among the 14 RTCs responding. The response rates to this area of the survey were low in part because of the fact that many
of the cooperatives reporting involvement in non-utility businesses had only begun these ventures in 1987 or 1988.

Finally, of the 37 respondents involved in non-utility businesses, 4 electric and 13 telephone cooperatives were willing to provide the sources of financing for their non-utility ventures. One of the 4 RECs and 10 of the 13 RTCs showed these ventures as entirely self-financed. Of the other three RECs, two had turned to the CFC and one to the Bank for Cooperatives (BFC) for loans to finance their non-utility activities. Of the remaining three RTCs, all had received financing from REA loan funds, one had received additional financing from a Rural Telephone Bank (RTB) loan as well, and one was partially funding its endeavor through internal sources. It should be noted, however, that all of these cooperatives had received large loans from REA and other sources, at below market rates, to fund their utility businesses.

1.2 The Survey of National LP-Gas Association (NLPGA) Members

This survey was performed in March 1988, to evaluate the potential competition between rural electric cooperatives (RECs) and members of NLPGA. NLPGA mailed the SVL Survey in its weekly newsletter to 2361 NLPGA members who are marketers of propane gas and associated appliances and are possibly subjected to competition from RECs. The survey was designed to aid in determining if RECs are competing with NLPGA members in business activities such as selling, servicing and installing products and equipment. There were 158 respondents to this questionnaire. Results are detailed in the table shown in Appendix B.

As shown in Appendix B, 49% of the respondents with complaints stated that RECs sold products/equipment, 34% of these respondents indicated that RECs provided services, 30% indicated that RECs offered installation, and 13% stated that RECs offered rebates. In addition, 40% of the respondents indicated that RECs offered financing and 51% of the respondents pointed out that RECs were their major competitor in the market place. Furthermore, 34% of the respondents claimed that their businesses have been greatly hurt and 29% somewhat hurt by the competition of RECs. Finally, 37% of the respondents claimed that the RECs in their service areas engaged in questionable or deceptive advertising. In confronting the increased competition from RECs, 35% of the respondents decided to increase their advertising/marketing activities and 58% indicated that they have done "nothing special," even though some have filed complaints to state public service commissions/other public officials or joined a coalition to combat unfair utility practices.

To take the survey one step further, SVL has performed follow-up telephone calls to the NLPGA members who indicated that they were greatly hurt by the competition of cooperatives and have complained to their state regulatory commission or other public
officials. A summary table of these responses is presented in Appendix B.

The results of this survey indicated that cooperatives may have utilized government-sanctioned monopoly to subsidize the sales of new appliances which may induce consumers to switch from gas to electric and replace appliances at artificially low prices. In addition, one NLPGA member stated that the REC in his area had entered the propane gas market. To compete with the small propane gas business, this REC offered propane at a much lower price than the small business could profitably offer to consumers.

1.3 A Survey of the National Electrical Contractors Association Members (NECA) Concerning Electric Utility Competitive Activities and Litigation

A study entitled "A Survey of Electric Utility Competitive Activities and Litigation" was prepared for the National Electrical Contractors Association (NECA) on July 6, 1988, by Enviro-Management & Research, Inc. of Springfield, Virginia. The objective of this study was to determine the nature, extent and effect of present and planned future competitive activities of electric utilities nationwide which go beyond the balance of their primary mission which is generating and transmitting electrical energy. In an attempt to gain further insight into the nature of the complaints, SVL has contacted the NECA state chapter managers to obtain additional information.

The results of this survey concerning competitive activities of cooperatives with NECA members are presented in Appendix C. According to the survey, competition problems with cooperatives were reported in seven states (Arkansas, Georgia, Illinois, Kansas, Minnesota, Mississippi, and Wyoming). The nature of the complaints can be summarized as follows: cooperatives offer installation of free outdoor electrical lighting to compete with electrical contractors for construction work and installation of wiring and equipment in commercial buildings, campgrounds, and other public facilities.

2. ECONOMIC ISSUES:

As discussed in Section III. C., the National Rural Electric Cooperative Association (NRECA) has strongly encouraged rural electric cooperatives to become involved in the "Rural Economic Development" program to improve the economic condition of rural communities.

The motivations and incentives for the management of those cooperatives which diversify into non-utility areas are at the heart of the economic issues such activities raise. Utilities cite many reasons for pursuing diversification. These include such obvious motivations as seeking profit-making opportunities and the
chance to increase returns to the cooperatives as well as such factors as making better use of and developing staff and management skills, attracting better managerial talent, fostering community development and public relations, and, for electric utilities, managing load to maximize return on generating capacity and avoiding expenditures for development of additional capacity.

The advantages of a diversified enterprise which management may hope to achieve include reduced financial risk and enhanced growth potential. Risk reduction and a lower cost of capital could theoretically be accomplished through establishment of a subsidiary by spreading total company risk over more than one industry.

It was pointed out by the National Association of Regulatory Utility Commissioners (NARUC), however, that while utilities are subject to substantial variations in earnings within a narrow band and that exposure to this variation may be complicated by regulation which is slow to react to changes, diversification may not be expected to lower a utility's cost of capital. This is because diversification takes the utility into unregulated, competitive markets which may offer higher returns but can be expected to entail higher risks as well. The cost of capital for the combined utility and non-utility activities is therefore likely to be higher than what it would be for the regulated utility activities by themselves.¹

In the case of a utility cooperative, it would appear to be even more likely than in the case of an investor-owned utility that diversified activities would lead to a higher overall cost of capital for the cooperative because of the low-cost funds which cooperatives have access to for financing their utility endeavors.

A further concern is that even if successful diversification might lead to a lower cost of capital, the utility may not be successful in the diversified activities pursued. A failure in these activities may lead to an increased cost of capital for the utility. This would adversely affect ratepayers if the higher financing costs were passed along to them.

Since organization as a cooperative means, by definition, that ratepayers are also owners in the utility, these costs would have to be passed on to them as decreased profits even if utility rates were not increased. This presents a particularly confusing situation for regulators who are normally concerned only with the effects of diversification on ratepayers through increases in rates. Public utility commissioners do not usually worry about the

welfare of shareholders of the utilities they regulate because most utilities are organized as investor-owned corporations. For RECs and RTCs, however, ratepayers are shareholders.

Another managerial motivation for pursuing diversified activities may also have a detrimental effect on ratepayers. While the chance to manage diversified subsidiaries may provide an incentive to improve managerial talent, it is possible that such talent will be taken away from the management of utility operations in order to concentrate on diversified enterprises. This would leave the traditional utility with a poorer quality management rather than an improved one.

Also, if the return from diversified operations is greater than that from traditional utility activities, management may be tempted to shift investment priority to diversified subsidiaries. Regulators must somehow assure that a sufficient level of investment in utility operations is maintained so that adequate service is provided to utility customers.

The allocation of common costs between the utility and its diversified businesses may also be a problem. Management is recognized to have a strong incentive to assure that diversified activities are not allocated more than their fair share of common costs. Management does not have such a strong incentive to prevent the over-allocation of such costs to utility operations, however, because these costs can be recovered from utility ratepayers. (For a further discussion of the problems inherent in the allocation of joint costs see the sections on operations and cross-subsidization below.)

3. FINANCING

RECs and RTCs enjoy considerable advantages over their small business competitors in terms of the financing of their endeavors. First, the cooperatives have access to Rural Electrification Administration (REA) loan funds at a five percent rate of interest. As noted in an earlier section of this report, these funds were authorized by the United States Congress in order to ensure that rural residents would be able to gain access to the benefits of electrification. Estimates suggest that today 99 percent of America's farms are receiving electricity. The cooperatives, however, still have access to these below-market rates.

\[\text{Ibid., p. 16.}\]

\[\text{This statistic is quoted in a letter dated May 28, 1987, from William M. Reckinger III, Chairman of the Alliance for Fair Competition, and Daniel N. Meyers, Vice President of Government Relations and General Counsel for National LP-Gas Association.}\]
As discussed in Section III. D, REA has a team of field accountants that perform loan fund and accounting reviews. Funds advanced in noncompliance with 7 CFR 1711.1 and unapproved disbursements are both considered "disallowances" by the REA Borrower Accounting Division. For Fiscal Year 1988 (10/1/1987 - 9/30/1988), REA had 39 field accountants who performed 828 audits. Additionally, there were 151 loan fund and accounting reviews involving cooperatives in which "disallowances" were identified. These "disallowances" totaled $19.8 million in Fiscal Year 1988. As mentioned previously, however, REA is not aware of any disallowances involving the use of REA funds for diversified activities.

In addition to REA funding and Energy Resources Conservation (ERC) loans, cooperatives can borrow money at rates lower than any small business competitors could hope to have made available to them because of the loan guarantee program of the National Rural Utilities Cooperative Finance Corporation (CFC). The high investment ratings given to the packaged CFC guaranteed bonds allow cooperatives to borrow at very favorable rates.

Naturally, cooperatives have been able to use these financing advantages to offer low-interest financing on products or equipment that they sell, service or install for their customers. 40 percent of those responding to the survey of National LP-Gas Association members stated that the cooperatives in their area offered financing. Additionally, 13 percent of the respondents indicated that the cooperatives offered rebates. This response may be an underestimate since no questions were asked about rebate programs.

On December 21, 1987, Section 313, Cushion of Credit Payments Program, was added to the Rural Electrification Act. Section 313 establishes a Rural Economic Development subaccount and authorizes the Administrator of REA to utilize funds in this subaccount to provide zero interest loans or grants to RECs/RTCs for the purpose of promoting "rural economic development and job creation projects." A financing program of this kind will almost certainly put some businesses at a competitive disadvantage with cooperatives who receive grants and zero interest loans.

In a letter to the editor of Human Events, September 1984, Mr. Harold V. Hunter, the Administrator of REA, made the following statements in response to the low interest loan program to cooperatives:

"I can readily understand how you at HUMAN EVENTS, as well as Mr. Lesher of the U.S. Chamber of Commerce, might assume that the administrator of an agency would welcome the grant of billions of dollars to that agency [HUMAN EVENTS, June 23]. However, I do want to set the record straight that the gifts from the U.S. Treasury to REA,
which are proposed in S 1300, are not in the best interests of either REA as an agency or of the people to whom REA services should accrue.

Soon after REA was established in the '30s, a goal was set to "turn the lights on in rural America."

REA provided loans to farmer cooperatives since bankers did not consider investments in rural electric services a feasible venture. Even in those difficult times, REA loans were at an interest rate of more than the cost of Treasury borrowing. The only benefit to the cooperative was the availability of the capital. There was no subsidy.

In contrast to the integrity of that Depression-era program, S 1300 proposes that REA loan interest rates be established at a strongly subsidized level--less than one-half the cost of money to the federal treasury. This subsidy would be accomplished by a major infusion of federal finances into an REA revolving fund.

This proposal disavows the proud heritage which was established in those truly difficult, early years when farmers banded together to do a job for themselves and the nation -- willing to pay the full cost and more for the use of needed capital, asking only that the capital be made available to them. There was no subsidy.

Today, those sparsely settled rural communities of yesteryear have achieved a coveted lifestyle. Urbanization has enriched the economy of some.

Today, the cooperatives are sophisticated, competent, well-organized, effective business organizations. Private sector bankers are now willing to loan at least part of the capital needed to assure that "the lights continue to burn in rural America." There is no need for a subsidy.

In spite of this transition, the sponsors of S 1300, the trade association which represents that industry, now propose that billions of taxpayer dollars be put into a revolving fund for the purpose of subsidizing an industry which is no longer the struggling infant in the raw Depression country of the '30s.

A low REA loan interest rate will result in minimal benefits to the ratepayers "at the end of the line." Rates charged by a distribution cooperative are the sum total of the various costs of operation of that
cooperative. The portion of those costs of operation which is needed for the payment of interest on the cooperative's loan from REA amounts to only 4.4 percent of the total.

For each percentage point that such interest rate is decreased, the benefit to the average rural residential cooperative member is only about one-half penny per day. This daily difference of one-half penny translates into only about 15 cents on each customer's monthly bill.

S 1300 is even more objectionable in light of the transcending need to bring federal spending under control and to contain federal deficits.

S 1300 is a complex piece of legislation. It contains numerous other controversial proposals. However, the major issue is simply whether the Revolving Fund should be made truly self-sufficient -- or should there be a subsidy of several billions of dollars in order to keep REA loan interest rates low.

There is no need for a subsidy."

As shown in Table 1, REC/RTC loans are about 16 percent of the Federal Government's outstanding Direct Loans.

Table I


<table>
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<th>Program</th>
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<td>Farmers Home Administration</td>
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<td>Rural Electric and Telephone</td>
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<td>Commodity Credit</td>
<td>23.6</td>
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<td>Export-Import Bank</td>
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<td>Small Business Administration</td>
<td>7.4</td>
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<tr>
<td>Other</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$221.9</strong></td>
</tr>
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</table>

(all figures in billions)

Source: Office of Management and Budget, Insight, January 30, 1989

* Figures do not add up to totals due to rounding

As shown in Appendix D, on July 13, 1988, Congressman Jim Bates (D-CA), along with Congressman Joseph DioGuardi (R-NY), introduced a bill in Congress to reform the REA's loan program. The purpose of the bill was to correct the inequities in the REA loan program and reduce the federal budget deficit by $5 billion.
In the letter to Congressman Bates and Congressman DioGuardi, Mr. James C. Miller III, Director of the Office of Management and Budget, Executive office of the President, stated:

"I commend your foresight and leadership in sponsoring Rural Electrification Administration (REA) reform legislation. The bill would prevent the financial insolvency of the REA's revolving fund, reduce the subsidized REA lending programs' extremely high costs to the U.S. taxpayer, and help ensure that REA borrowers will not have an unfair competitive advantage against nonsubsidized taxpaying businesses."

It is important to point out that cooperatives may have financed their non-utility ventures with private capital or with a CFC loan package. However, without the tremendous asset base, the credit rating and the management talents of the government-sanctioned monopoly which was financed with REA loans, cooperatives would have difficulty obtaining financing to diversify into non-utility businesses, or they would be required to pay a much higher cost of capital which would translate to a higher rate of return and higher price of services offered to consumers in the competitive sector of the economy.

4. MARKETING

When a utility establishes a subsidiary which offers products to area consumers, the subsidiary starts out with marketing advantages which no new independent enterprise would have. Utilities have access to customer research information in such important areas as credit ratings and energy usage, plus any other market research studies which the utility might have decided to conduct, at utility ratepayer expense, prior to beginning the non-utility venture. Since market research data is necessary to any utility, expenditures for these studies would not likely be challenged in a rate hearing. The non-utility ventures may then enjoy access to this information at no cost.

Another initial marketing advantage that the non-utility enterprise has is the name recognition of the parent utility. Certainly every rural consumer is familiar with the name of the cooperative which provides him with electricity or telephone. It is common practice for product advertisements to prominently display the cooperative's name and logo.

Cooperatives are also able to add charges incurred for non-utility business activities to their utility customers' monthly bills with little or no expense for the non-utility business. This allows customers of the subsidiary to make convenient monthly payments. All of these costs would be borne by the non-utility business if it were not affiliated with a cooperative.
Non-utility enterprises also have access to the results of energy audits made by the utility. The National Energy Conservation Policy Act (NECPA) and the Energy Security Act (ESA) required utilities to conduct low or no-cost energy audits through the Residential Conservation Service (RCS) and Commercial and Apartment Conservation Service (CACS). Although the RCS prohibited utilities from selling and installing conservation measures, there was a grandfather clause allowing utilities to continue to provide these products if they had been doing so prior to the passage of this legislation. The CACS contained no such prohibition at all. These programs were substantially altered by the Conservation Service Reform Act which repealed most of the CACS program and revised the RCS program. REA cooperatives have access to ERC loan funds to assist their customers in purchasing these conservation measures, often from the cooperatives themselves. In response to the survey of National LP-Gas Association (NLPGA) members, 49 percent of the respondents said that the cooperatives in their area sell products or equipment.

Often energy audits have led to product recommendations which encourage and promote fuel switching. This runs counter to Congressional and Department of Energy (DOE) policies against fuel switching. Still, rebates are offered by some RECs for the purchase of such items as electric water heaters if the customer turns in a gas or propane heater. Terms of sale may depend on whether the homeowner is converting to electric or replacing an existing electric heater. Also, some RECs maintain different rate structures for customers who utilize all electric as opposed to using privately furnished fuel.

Also, advertisements by RECs often allude to the dangers of gas use. Through cartoons, editorials, and articles featured in cooperative bill stuffers, many RECs suggest to their customers that gas usage is unsafe. In response to the survey of NLPGA members, 37 percent of the small businesses responding said that the cooperatives in their area engaged in questionable or deceptive advertising.

Even when a cooperative does not sell or install electrical appliances, the cooperative may maintain a list of approved merchants who do. These utilities may favor certain contractors and thus still affect the competitive market. When asked if the cooperatives in their area have a list of approved merchants who sell or finance equipment, 26 percent of the respondents to the survey of NLPGA members said yes.

In the current open docket No. 3618-U, before the Georgia Public Service Commission, associated with the Commission's Investigatory Docket into Promotional Practices of All Regulated Energy Companies, the Georgia Propane Gas Association, Inc., stated:

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"promotional practices engaged in by EMC's (Electric Membership Corporations/Cooperatives) run the gamut from outright substantial cash payments to long-term, no interest loans......

One of the more aggressive EMC's in terms of promotional practices is Carroll EMC. Under the Carroll EMC program, a member could receive a rebate of $480 for installing an electric heat pump and also get a free hot water heater......

Cobb EMC, in the heart of metropolitan Atlanta, pays $250 for installation of a heatpump, but only if gas heat is not used with it......

The extent of the problem is perhaps best exemplified by the giveaway of water heaters. Testimony in this record showed that the increased annual operating cost of an electric water heater exceeded the value of that free water heater."

In the Recommended Order of this docket, the Hearing Examiner stated:

"The use of monetary inducements to choose a particular energy source constitutes unfair competition, reduces consumer choice, creates economic inefficiencies and discourages the conservation of energy."

In Maryland, however, the Code of Regulations prohibited promotional practices by any utilities such as providing free, or at less than cost or value, wiring, piping, appliances, or equipment to a person (Appendix E).

5. OPERATIONS

A utility and its non-utility operations share many joint costs of operation. The allocation of these joint costs in line with generally accepted accounting principles is an inherently arbitrary process and remains a problem for regulatory overseers.

Non-utility operations may share overhead such as office space, company vehicles, computers and other equipment, trained personnel, and managerial talent with a parent utility. If, for example, a REC maintains a fleet of trucks for utility operations, the cooperative may use those trucks in some other business during slack periods, provided that all avoidable costs are charged to the non-utility business. That non-utility operation may, therefore, never have to bear the cost of owning or leasing vehicles for its operations as its small business competitors must.
As Frank S. Swain, Chief Counsel for Advocacy of the U.S. Small Business Administration, notes in commenting on these overhead costs:

"If these costs were borne in part by the ratepayer, no real saving would be achieved. The sole result of improper allocation is that small business competitors may be forced out of markets."

Perhaps the most thorny question for regulators of diversified utilities is that of the valuation of intangible assets transferred from the utility to its subsidiary or shared by the business ventures. These intangible assets include the consumer research and goodwill mentioned in the section on marketing as well as such items as sophisticated computer software.

It should be noted that the Federal Regulatory Commission (FERC) and FCC Uniform System of Accounts (U.S.O.A.) are not very helpful to regulators in uncovering cross-subsidization. These systems were not designed to track costs between companies. The U.S.O.A. does not require maintenance of cost data on a functional cost center basis. Thus, utilities and regulators typically lack needed data to allocate costs between utility and non-utility activities on a functional basis.

6. SPECIAL TAX TREATMENT

The federal income tax treatment of a rural telephone cooperative (RTC) or rural electric cooperative (REC) is governed exclusively by §501(c)(12) of the Internal Revenue Code of 1986 (the "Code"), together with IRS regulations and revenue rulings promulgated thereunder, and applicable case law. Both RECs and RTCs are specifically excluded from the application of Subchapter T of Chapter 1 of the Code. [Code §1381(a)(2)(C); Reg. §1.1381-1(b)(4)].

General Requirements for "cooperative" Status

In order to be considered a cooperative for federal income tax purposes, an organization must first meet several operational criteria: (i) the interests of the members must be proportional to the value or quantity of purchases made; (ii) capital gains must be distributed, insofar as is practicable, solely among those who were members of the organization during the period of appreciation; (iii) no member's interest may be forfeited pursuant to any bylaw of the organization; (iv) organizational funds may not be retained beyond current operating costs except to meet reasonable business needs; and (v) a detailed record must be kept of each member's interest in any such retained funds. [Revenue Ruling 72-36, 1972-
1 CB 151, modified by Revenue Ruling 81-109, 1981-1 CB 347]. If an organization meets these five operational criteria it must then also meet the 85% member-income test, described below, before it will be granted federal tax exemption as an RTC or REC.

The 85 Percent Member-Income Test

Under present law, a cooperative telephone company or like organization is exempt from federal income taxation if and only if at least 85 percent of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to such members. [Code §501(c)(12)(A)]. The term "like organization" is deemed to include, among several others, any organization that furnishes electricity to its members on a cooperative basis. [Proposed Reg. §1.501(c)(12)-2(a)]. Thus, an RTC or REC which meets the 85% member-income test and is otherwise operated as a bona fide cooperative is entitled to federal income tax exemption, while an organization that has income from outside activities greater than 15% is not exempt, whether or not it meets the operational criteria of a cooperative. [Allgemeiner Arbeiter Verein vs. Commissioner, 25 TC371, aff'd (3d Cir. 1956), 237 F. 2d 604, 50 AFTR 513].

Unlike certain other types of 501(c)(12) organizations, neither an RTC or REC must be "of a purely local character." In other words, neither is required to confine its business activities to one particular community, place or district. [Reg. §1.501(c)(12)-1(b)].

Tax on Unrelated Business Income

Section 501(c)(12) organizations are now within the scope of the unrelated business income tax, such that a cooperative which is otherwise tax exempt on account of its ability to meet the 85% member-income test will nevertheless pay tax, at the regular corporate rate, on that portion of its income constituting unrelated business taxable income (UBTI). [Code §511(a); Reg. §§1.511-1, 1.511-2]. However, having "UBTI" for the year does not mean that the RTC or REC loses its overall tax exemption under Code §501(c)(12); it simply means that to the extent the cooperative has any net income attributable to a business activity regularly carried on by it which is not substantially related to the organization's exempt purpose or function, such income -- and such income only -- will be taxed in the same manner as that of any taxable corporation. [Code §512(a)(1); Reg. §1.513-1(a)]. Excluded from UBTI are all earnings from the organization's exempt-function activities and most types of passive income, such as interest, dividends, rents, royalties, capital gains & losses, and so on. [Code §512(b)(1), (2), (3), (4), (5)].
The tax exempt cooperatives have a clear advantage over their	nonsubsidized taxpaying business competitors such as the National
LP-Gas Association members and the National Electrical Contractors
Association members. It is apparently the case that RECs and RTCs
engaged in diversified activities, which were claimed to be
"related" to their electrical/telephone services, may nonetheless
be able to qualify for the 501(c) treatment and compete directly
with the nonsubsidized businesses who do not enjoy an exemption
from income taxation.

In the Comptroller General Report to the Congress of the
United States entitled "Legislation Needed To Improve
Administration Of Tax Exemption Provisions For Electric
Cooperatives," GAO/GGD-83-7, January 5, 1983, the General
Accounting office (GAO) stated:

"Section 501 (c)(12) originated with the Revenue Act of
1916. That act provided tax-exempt status to, among other
organizations, mutual or cooperative companies which
derived their income solely from members. At that time
corporations were subject to a 2 percent income tax.
Although congressional intent for exempting cooperatives
and like organizations is vague, the House Committee on
Ways and Means report accompanying the 1916 act indicated
that the negligible amount of tax that would be collected
from these organizations did not justify the expense and
annoyance of close administration. Another view,
according to one authority on tax exemption, is that the
Congress desired to assist small mutual and cooperative
associations formed by struggling farmers and businessmen
during this precarious economic period."

"Since electric cooperatives were first granted tax
exemption in 1924, many of them have grown and changed.
IRS has tried to recognize the wide diversity among
electric cooperatives when administering tax exemption
provisions. However, it has had difficulty doing so
because of broad legislation which generally exempts all
such cooperatives from paying taxes regardless of
differences in their operations and activities, financial
condition, size or mix of consumers served."

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

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

"GAO recommends that the Congress establish a tax treatment to better recognize the changes in electric cooperatives' operations and activities. To this end, GAO proposes alternatives to the present law which would (1) modify electric cooperatives' nonmember income allowance, or (2) eliminate that allowance, and/or (3) apply tax rules already applicable to other types of cooperatives."

In its conclusions, GAO stated:

"Tax exemption, as presently structured, applies across-the-board to all electric cooperatives regardless of the extent and nature of their operations and activities. Yet, many cooperatives have progressed to the point where they closely resemble their for-profit counterparts and earn substantial tax-free income from nonmember sources which subsidizes their members' cost of electricity. In view of this, we believe the Congress should evaluate alternative tax treatments and adopt one which would better recognize the changing operations of electric cooperatives and their continuing need for assistance in today's environment. Such alternatives might include, but need not be limited to:

- Providing limited tax assistance to cooperatives by replacing the 85 percent member income provision with a nonmember income exclusion.

- Eliminating the nonmember income allowance which permits cooperatives to earn untaxed income from nonmember sources.

- Making Subchapter T rules applicable to electric cooperatives."

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7. CROSS-SUBSIDIZATION AND POTENTIAL UNFAIR COMPETITION

The diversification of cooperatives and regulated utilities into non-utility businesses has significant implications to the competition in the unregulated markets, particularly the effect of this diversification on the ability of certain small businesses to survive. The utility diversification could affect utility rates as well as the price and supply of other goods and services. From a utility ratepayer and regulator point of view, one of the potential disadvantages of utility diversification is the possibility of undue subsidization by the utility's monopoly business of the non-utility's costs. Cross-subsidization can result in the misallocation of direct or joint costs to a utility's regulated activities. Cross-subsidization could exist in a number of forms. The potential cross-subsidization in the areas of financing, marketing, operations, and special tax treatment were discussed in detail in the previous sections. In the document entitled "Fact Sheet - Utility Holding Companies," 1983, the Wisconsin Department of Justice stated:

"One of the big selling points for diversification has been the idea that the utility has people, equipment and other resources that could be shared and thus made more productive. The fact is that each time a service or asset is shared somebody has to figure out the components of direct and indirect cost and allocate those costs between utility and non-utility operations. The cost share assigned to the utility operation will go into utility rates while anything not allocated to the utility must come out of non-utility profits. There is an unavoidable incentive to favor non-utility ventures and it is virtually impossible for the PSC to monitor the thousands of small judgments that will filter down to a cost allocation. It is highly probably that utility ratepayers will pay part of the costs of the diversified new ventures."

Cooperatives could utilize their monopoly advantages such as financing, credit rating, marketing, operations and special tax treatment, to subsidize the operations of their non-utility business in two ways. First, the utility may sell, service and install appliances, heating and cooling equipment at very low prices to encourage fuel switching and capture the largest possible market share for the type of energy which they provide. The competition by the cooperative utility for an increased share of the utility market encourages every effort to sell and install the largest number of appliances at artificially low prices. These actions will cause to disrupt the markets of appliances, installation services, and the fuel markets. Second, cooperative utilities may allow the non-utility enterprise to sell, service or install their products at a price below the cost of its competitors. The utility can obtain a significant portion of the
market for its new product and in the process may drive a number of its competitors from the market. In the new environment of reduced competition, the cooperative could raise prices, recouping its foregone income in a classic example of predatory pricing forbidden by the antitrust laws.

Competition with monopoly utilities in the non-utility market can result in the destruction of small business competitors who do not have the low cost financing, management talents, marketing advantages and special tax treatment. These types of cross-subsidization could fall under FTC jurisdiction to bar violations of the spirit and the letter of antitrust laws, and to stop incipient activities that would violate antitrust statutes. As discussed in Section III. E., the Sherman Act prohibits monopolization and attempts to monopolize and conspiracies in restraint of trade. The Clayton Act outlaws price discrimination practices as well as exclusive and fixing contracts. Also, section 5 of the FTC Act states:

"Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce are hereby declared unlawful." [15 U.S.C. sec 45(a)(1)(1976)].

The theoretical and practical justification of our market economy is that it brings about the most efficient resource allocation consistent with the basic economic freedom that our society demands. In general, the entry of additional competitors into a certain market will enhance free and open competition. However, if a new entrant possesses a competitive advantage which is not based on its being an efficient producer, such as using a government-sanctioned monopoly to subsidize its new business, then consumer and efficient competitors will suffer. Cross-subsidization can result in a misallocation and waste of society's resources. For example, based on the survey of National LP-Gas Association (NLPGA) members (Appendix B), a cooperative's cross-subsidization of the sale of new appliances may induce consumers to switch from gas to electric and purchase new appliances at artificially low prices in situations where it may be more efficient for the consumer to repair older appliances and use gas which may be a cheaper source of energy as shown in table 2:
Table 2. Representative Average Unit Costs of Energy for Five Residential Energy Sources (1989)

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<tr>
<th>Type of energy</th>
<th>Dollars per million Btu (British Thermal Unit)</th>
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<tr>
<td>Electricity</td>
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<td>5.52</td>
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<td>No. 2 Heating oil</td>
<td>5.62</td>
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<td>Propane</td>
<td>7.88</td>
</tr>
<tr>
<td>Kerosene</td>
<td>5.55</td>
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</tbody>
</table>


In a hearing on "Competition by Utilities in Energy Conservation and Home Appliance Markets" before the Senate Committee on Small Business, November 3, 1983, Mr. Timothy J. Muris, Director of Bureau of Competition, Federal Trade Commission, stated:

"Utility entry may, however, ultimately reduce competition. If utilities can subsidize unregulated ventures with revenues from their core activity as regulated utilities--in which a specified rate of return is virtually assured--they may eliminate independent firms, securing much of the market for themselves."

"When a firm assigns costs attributable to an unregulated business to its regulated activity, cross-subsidization occurs. More important, the firm can set its price below its true costs in the unregulated market, to the detriment of competition. Thus, a utility may engage in predation, while passing the costs on to its energy customers. Such cross-subsidization could allow a utility to drive from the market even an efficient and well-managed independent that did not have access to similar subsidies."

In the hearing on "Regulated Monopolies Competition with Small Business" before the Subcommittee on Antitrust and Restraint of Trade Activities Affecting Small Business, of the House Committee on Small Business, Mr. Winston S. Moore, Assistant Director, Bureau of Competition, Federal Trade Commission, stated:

"If cross-subsidization were carried out to the extent that the utility was able to set its prices in the unregulated market below its actual costs, then it might be able first to drive from the market even the most efficient competitors that lacked the ability to cross-subsidize, and then to raise its prices and obtain monopoly profits. This conduct, if successful, would
constitute a violation of the Sherman Act and could form the basis for an FTC challenge to the utility."

Based on the survey of NLPGA members (Appendix B), a cooperative has entered the propane gas business and offers propane at a much lower price than its competing small propane gas business could profitably offer to consumers. In addition, electric cooperatives have offered rebates, free appliances and below market rates for electricity, as well as labor for installation to customers who convert from gas to electric appliances. Based on the survey of NECA members (Appendix C), cooperatives offer installation of "free" outdoor electrical lighting and compete with electrical contractors for construction work and installation of wiring and equipment. The argument between small businesses and cooperatives in the areas of selling appliances, offering free electric water heaters through potentially unfair promotional practices, cost allocation, cost of service analysis and cost based pricing policy have recently been brought to the attention of the Supreme Courts of the states of South Carolina and Georgia. The following South Carolina and Georgia cases were included in the "Case Study" section of this report:

1. Able Communication, Inc. versus the South Carolina Public Service Commission and Farmer's Telephone Cooperative, Inc. This case suggests that RTCs may set rates without an appropriate cost study, which may create the potential for cross-subsidies, particularly where there is no regulatory oversight of RTCs.

2. Horace B. Avant, Jr., Marion E. Anderson, and Satellite TV Dealers of Georgia, Inc. versus the Washington Electric Membership Corporation, and Burts V. Register, and Satellite TV Dealers of Georgia, Inc. versus the Little Ocmulgee Electric Membership Corporation and Little Ocmulgee Service Corporation. In this case, according to the state supreme court ruling, Georgia Electric Membership Corporations are forbidden from selling satellite television equipment to non-members.

3. The Georgia Public Service Commission's Investigatory Docket Into the Promotional Practices of All Regulated Energy Companies. The Hearing Examiners's recommended decision in this case states that certain promotional practices such as the use of monetary inducements to promote fuel switching, constitutes unfair competition, reduces consumer choice, creates economic inefficiencies, and discourages the conservation of energy.

Also, based on SVL's Survey of the state regulatory commissions with jurisdiction over REC rates, the state regulators were not aware of any cost-benefit studies to prove or disprove the cost justification of "free" appliances and "free" outdoor lighting.
electrical lighting programs offered by RECS. However, the Code of Maryland Regulations includes a law (Title 20 - Subtitle 40) that prohibits "promotional practices" by any utility such as providing free, or at less than cost or value, wiring, piping, appliances or equipment (Appendix E).

In addition to problems associated with cross-subsidization, some cooperatives could also be engaged in using the utility's marketing advantages to increase the market share of the non-utility business. As an example, a cooperative may allow its non-utility enterprises to add their bills directly on to the monthly utility bill. This allows customers of the subsidiary to make convenient monthly payments, for the purchase of new appliances, heating equipment or other products. The simple credit and billing arrangement is only available to the cooperative's customers who buy their appliances or products from the utility. Other customers of small business competitors do not have access to the same advantageous arrangement. The cooperative may be using its economic power in its monopoly market to extend its economic power into new markets and foreclose competition, an action declared illegal by Section 3 of the Clayton Act. *Fortner Enterprises vs U.S.Steel Corporation*, 394 U. S. 495,508 (1969).

The Federal Trade Commission Act's prohibition of unfair methods of competition gives the FTC the authority to forbid attempts to monopolize a market through predatory practices. The FTC Act gives the Federal Trade Commission broad authority to protect fair competition whenever it is threatened by oppressive or unfair tactics. Therefore, the FTC has the authority to prevent unfair methods of competition by cooperatives in unregulated markets.

State Public Service Commissions (PSCs) do not regulate the non-utility businesses owned by public utilities and cooperatives. The PSC could take action to prevent the subsidiary from impairing utility service. However, the PSC does not have authority over price, product, profit or other non-utility business decisions of the subsidiary. PSCs are primarily responsible for utility ratepayers and they may not have the authority or the resources to respond to complaints about utility activities which do not harm ratepayers. Generally, illegal cross-subsidization is of particular concern to PSCs due to the fact that improper cross-subsidization of a non-utility business by a monopoly utility may result in ratepayers bearing costs for which they are not responsible. However, as discussed in Section III. E, based on our survey, most states do not regulate the rates of cooperatives or the diversification of cooperatives. Therefore, illegal cross-subsidization of cooperatives may never be discovered by any regulatory agencies.

Similar to investor-owned utilities, RECs generally utilized a Uniform System of Accounts (U.S.O.A.) for accounting and record
keeping purposes. In a study titled "Regulating Electric Utilities With Subsidiaries," 1986, the National Regulatory Research Institute stated:

"Although the U.S.O.A. may have been adequate for the informational needs of utilities and regulatory authorities in the 1930s and 1940s, many observers contend that they no longer provide sufficient information for either utility management or regulators in today's complex regulatory and nonregulatory environments."

"One example of how regulators face informational constraints with the U.S.O.A is in the area of cost allocation. Since the U.S.O.A. does not require the maintenance of cost data on a functional cost center basis, utilities (and thus regulators) typically lack the necessary data to allocate overhead costs between regulated and nonregulated activities on a functional basis. Utilities (and regulators) lacking this kind of information must resort to other, less precise, cost allocation methods such as the application of overall (firm-wide) formulas."

"Another problem for regulators is posed by the aggregation of accounts relating to transactions with affiliated companies...............Since there are no separate income/expense accounts for payments to/from subsidiaries in affiliated transactions, these expenses or revenues are recorded in the utility's functional revenue/expense accounts, along with expenses/revenues paid/received in arms-length transactions with nonaffiliated entities. Thus, the aggregate amounts of payments and receipts from subsidiaries are "buried" in the functional income and expense accounts. The end result is that the utility's financial statements have little useful informational content for regulatory authorities."

Based on the information obtained from the informal communication dated January 17, 1989, REA audits all loan funds advanced to and disbursed by REA borrowers. In addition, REA requires that every borrower have an annual audit conducted by an approved Certified Public Accountant (CPA). If a borrower has a wholly-owned subsidiary, REA cannot demand its records unless it has loaned funds to finance its operation. As of 1988, the CPA audit will help REA to identify borrowers with subsidiary operations, however, it does not provide information associated with cross-subsidiation. Therefore, illegal cross-subsidization of cooperatives within the states that do not regulate cooperative rates may never be discovered.
Most state regulatory commissions, including the states which regulate cooperatives, do not require RECs/RTCs to submit cost allocation studies for review. Additionally, neither the CPA audit or REA audit require a review of cost allocation procedures. Under these circumstances, it would appear likely that, as in the Able Communications Inc. versus the South Carolina Public Service Commission and Farmers Telephone Cooperative, Inc. case study, cooperatives may be lax in performing these studies, thereby increasing the potential for cross-subsidization.

Most small businesses facing unfair competition from illegal cross-subsidization of cooperatives do not have the large amount of time, effort and money required to challenge cooperatives in courts. Therefore, unless cooperatives are being regulated, state regulators have the procedures for tracking and allocating costs between utility and non-utility portions of the business, and the FTC actively looks into the unfair competition issues, small businesses will most likely continue to face unfair competition from illegal cross-subsidization of cooperatives, markets will be disrupted, and resources will be misallocated.

8. CONCLUSIONS

The arguments between small businesses and cooperatives, such as selling appliances, cost of service/cost allocation, cost based pricing policy and promotional practices of cooperatives which were recently brought before the state Supreme Courts of South Carolina, Georgia and the state Public Service Commissions, suggests that cross-subsidization and unfair competition may indeed exist due to inadequate regulation of cooperatives across the country. While investor-owned utilities are regulated, the results of our survey indicate that many cooperative utility rates and their diversification operations are not subject to any regulation. Rural Electrification Administration (REA) audits loan funds advanced and disbursed by REA borrowers and also requires a CPA audit. However, these audits do not reveal information to detect cross-subsidization. Therefore, illegal cross-subsidization of cooperatives within the states which do not regulate cooperative utility rates may never be discovered by any regulatory agencies.

It is clear that if cross-subsidization is not detected and prevented, cooperative utilities could utilize their monopoly advantages, such as financing, credit rating, marketing, operations and special tax treatment to subsidize the diversified ventures in the competitive sectors of the economy. If this occurs, utility ratepayers are forced to subsidize the diversification program; a cooperative can set its price below its true costs in the competitive markets and may eliminate from the market even efficient, well-managed competitors; ultimately, society resources will be misallocated.
The non-utility subsidiaries of diversified RECs and RTCs enjoy many advantages over their small business competitors. Some of these advantages are specifically mandated by federal legislation and others are implicit in the decisions of regulators. Under these circumstances, it is difficult for small businesses to compete.

It is also difficult for small businesses to file charges of unfair competition by these subsidiaries. This is partly due to the problem, noted in a previous section of this report, of identifying which regulatory body has authority over the cooperatives in a given state. An additional problem is the cost involved. Many commissions will not undertake their own investigations but, rather, require the complainant to provide detailed evidence of the alleged abuse. Unless some changes are made in the regulation of cooperatives and the required cost allocation study for cooperatives, it would seem likely that many small business competitors of the cooperatives will not survive.
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SVL Associates
REC/RTC Survey Summary Report on Cooperatives With Non-Utility Businesses

<table>
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<td>Responses</td>
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<tr>
<td>Percentage of population</td>
<td>37.3%</td>
<td>37.1%</td>
<td>37.3%</td>
</tr>
</tbody>
</table>
SVL Associates
REC/RTC Survey Summary Report on Cooperatives
With Non-Utility Businesses
Electric Cooperatives

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Non-Utility Business</th>
<th>Organized Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Appliance sales and service</td>
<td>1950</td>
</tr>
<tr>
<td>2</td>
<td>Satellite TV programming &amp; equip</td>
<td>1981</td>
</tr>
<tr>
<td>3</td>
<td>Natural gas sales</td>
<td>1988</td>
</tr>
<tr>
<td>4</td>
<td>Rural TV</td>
<td>1988</td>
</tr>
<tr>
<td>5</td>
<td>Satellite TV programming &amp; equip</td>
<td>1988</td>
</tr>
<tr>
<td>6</td>
<td>CATV for rural areas</td>
<td>1983 (sold 1988)</td>
</tr>
<tr>
<td>7</td>
<td>Satellite TV programming &amp; equip</td>
<td>March 1988</td>
</tr>
<tr>
<td>8</td>
<td>Telecommunication</td>
<td>July 1987</td>
</tr>
<tr>
<td>9</td>
<td>Fuel supply</td>
<td>October 1981</td>
</tr>
<tr>
<td>10</td>
<td>TVRO sales and programming</td>
<td>1987</td>
</tr>
<tr>
<td>11</td>
<td>Leasing de-scramblers, TV program.</td>
<td>January 1988</td>
</tr>
<tr>
<td>12</td>
<td>Telecommunication equip sales</td>
<td>January 1988</td>
</tr>
<tr>
<td>13</td>
<td>Rural TV</td>
<td>1988</td>
</tr>
<tr>
<td>14</td>
<td>TVRO satellite TV programming</td>
<td>1988</td>
</tr>
<tr>
<td>15</td>
<td>Satellite TV services</td>
<td>1988</td>
</tr>
</tbody>
</table>
SVL Associates
REC/RTC Survey Summary Report on Cooperatives
With Non-Utility Businesses
Telephone Cooperatives

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Non-Utility Business</th>
<th>Organized Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>TVRO &amp; customer premises equip</td>
<td>1983</td>
</tr>
<tr>
<td>2</td>
<td>Radio Shack</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>CATV</td>
<td>1981</td>
</tr>
<tr>
<td>4</td>
<td>2-Way radio sales and repair</td>
<td>1985</td>
</tr>
<tr>
<td>5</td>
<td>CATV</td>
<td>1987</td>
</tr>
<tr>
<td>6</td>
<td>CATV</td>
<td>1985</td>
</tr>
<tr>
<td>7</td>
<td>Sell &amp; install phone/radio equip</td>
<td>1987/1988</td>
</tr>
<tr>
<td>8</td>
<td>Computer store</td>
<td>March 1987</td>
</tr>
<tr>
<td>9</td>
<td>Cellular phone</td>
<td>April 1984</td>
</tr>
<tr>
<td>10</td>
<td>TVRO</td>
<td>January 1988</td>
</tr>
<tr>
<td>11</td>
<td>Interconnect for station apparatus</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>CATV</td>
<td>May 1982</td>
</tr>
<tr>
<td>13</td>
<td>CATV</td>
<td>1980</td>
</tr>
<tr>
<td>14</td>
<td>CATV</td>
<td>October 1986</td>
</tr>
<tr>
<td>15</td>
<td>CATV</td>
<td>1980</td>
</tr>
<tr>
<td>16</td>
<td>CATV</td>
<td>1981</td>
</tr>
<tr>
<td>17</td>
<td>Sales &amp; lease communication equip</td>
<td>1984</td>
</tr>
<tr>
<td>18</td>
<td>Sales of Telephone equip</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Paging system</td>
<td>1975</td>
</tr>
<tr>
<td></td>
<td>Sales of equip</td>
<td>1986</td>
</tr>
<tr>
<td></td>
<td>Cellular</td>
<td>1988</td>
</tr>
<tr>
<td>20</td>
<td>CATV</td>
<td>1982</td>
</tr>
<tr>
<td>21</td>
<td>Telephone sales and CATV</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Interconnect business</td>
<td>1984</td>
</tr>
</tbody>
</table>
APPENDIX B
Survey: Percentage Results

Does the Rural Electric/Telephone Cooperative (REC/RTC) in your area sell, service or install products or equipment?

<table>
<thead>
<tr>
<th>Sell</th>
<th>Service</th>
<th>Install</th>
<th>Other: Rebates</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>49</td>
<td>34</td>
<td>30</td>
<td>13</td>
<td>40</td>
</tr>
</tbody>
</table>

Does the REC/RTC offer financing?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>Don't Know</th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td>29</td>
<td>31</td>
</tr>
</tbody>
</table>

What type of competitor has the REC/RTC been in the marketplace?

<table>
<thead>
<tr>
<th>Major</th>
<th>Minor</th>
<th>Unknown</th>
</tr>
</thead>
<tbody>
<tr>
<td>51</td>
<td>30</td>
<td>20</td>
</tr>
</tbody>
</table>

How would you describe the impact that the REC/RTC has had on your business?

<table>
<thead>
<tr>
<th>Greatly Helped</th>
<th>Somewhat Helped</th>
<th>Had No Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>6</td>
<td>29</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Greatly Hurt</th>
<th>Somewhat Hurt</th>
</tr>
</thead>
<tbody>
<tr>
<td>34</td>
<td>29</td>
</tr>
</tbody>
</table>

How has your business responded to REC/RTC practices?

<table>
<thead>
<tr>
<th>Changed markets or product lines</th>
<th>Increased advertising/marketing</th>
<th>Lowered prices</th>
<th>Worked cooperatively with REC/RTC</th>
<th>Complained to Public Service Commission or other public officials</th>
<th>Joined a coalition to combat unfair utility practices</th>
<th>Done nothing special</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>35</td>
<td>17</td>
<td>4</td>
<td>9</td>
<td>5</td>
<td>58</td>
<td>4</td>
</tr>
</tbody>
</table>

Does the REC/RTC in your area have a list of approved merchants who sell or finance equipment?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>Don't Know</th>
</tr>
</thead>
<tbody>
<tr>
<td>26</td>
<td>42</td>
<td>32</td>
</tr>
</tbody>
</table>

Does the REC/RTC in your area engage in questionable or deceptive advertising?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>Don't Know</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td>51</td>
<td>11</td>
</tr>
<tr>
<td>NLPGA Member</td>
<td>REC</td>
<td>Nature of Complaint</td>
</tr>
<tr>
<td>--------------</td>
<td>-----</td>
<td>---------------------</td>
</tr>
</tbody>
</table>
| 1. Brefeld Gas Co. Clinton County Electric Cooperative  
21 W. Broadway  
Trenton, IL 62293 | Free electric water heaters are being offered to customers if they convert from their gas water heaters.  
Deceptive advertising. | Jerome Brefeld wrote a letter to NLPGA who passed it on to a Congressional meeting. |
| 2. Chester Hardware, Inc. Sioux Valley Electric Cooperative  
Box B  
Chester, SD 57016 | Rebates are being offered to customers who convert from gas to electric water heaters.  
Free electric water heaters are being offered to customers if they convert from their gas water heaters.  
Free electrical wiring to customers who replace any type of gas heating with an electrical heating device.  
Low-cost electrical wiring services.  
Deceptive advertising. | Mentioned at LP-Gas Convention. |
| 3. Sherman Plumbing & Heating Tri-County Electric Cooperative  
854 2nd St  
South Carrington, ND | Offering free or low-cost electric boilers, electric water heaters and plenum heaters for customers who replace gas heat devices.  
Deceptive Advertising. | Ellen Sherman talked personally to Senator Conrad, who has yet to respond.  
Ellen Sherman called North Dakota Public Utilities Commission (PUC) and was told they have no jurisdiction in the case. |
| 4. Simonsen Propane, Inc. Cherokee County Rural Electric Cooperative  
Box 39  
Quimby, Iowa 51049 | Offering below market rates for electricity, appliances and labor to install these appliances.  
Deceptive Advertising. | Jeff Simonsen wrote letter to Congressman Fred Grandy, who has yet to respond.  
Published an article entitled "Does Switching Really Make Sense" in the local Newspaper. Subsequently, Simonsen received telephone call from the lawyer of a REC who threatened to file suit. Therefore, Simonsen withdrew the article. |
<table>
<thead>
<tr>
<th>MLPGA Member</th>
<th>REC</th>
<th>Nature of Complaint</th>
<th>Action Taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Larson Plumbing &amp; Heating</td>
<td>Tri County Electric Cooperative</td>
<td>Offering free electric water heaters, furnaces, duct heaters, base boards and supplies to customers who convert from gas appliances and sign up for a long-term (5 yrs.) Off-Peak Program. Low-cost electric water heaters to customers who replace gas water heaters.</td>
<td>Complained verbally to a board member of North Dakota Plumbing, Heating and Cooling Contractors.</td>
</tr>
<tr>
<td>9. Drake Gas Co., Inc.</td>
<td>Jackson EMC</td>
<td>Cash rebates to customers who install an electric heat pump in place of gas heat. Deceptive advertising.</td>
<td>Sent letters to Senators Sam Nunn and Mack Mattingly urging them to vote against S.1300, the Rural Electrification and Telephone Revolving Fund Self-sufficiency Act of 1983, and the House-passed companion legislation (H.R. 3050). Senator Nunn responded with a letter stating that the bill was very controversial and that final action on it during the 98th Congress was uncertain, even though the House of Representatives had approved H.R. 3050 and the Senate Agriculture Committee had recommended passage. Senator Mattingly responded with a letter stating his strong support for S.1300 or other legislation that favored a strong, viable program at or near the current REA spending levels. Complained through MLPGA to a Subcommittee on Agricultural Credit and Rural Electrification.</td>
</tr>
<tr>
<td>NLPGA Member</td>
<td>REC</td>
<td>Nature of Complaint</td>
<td>Action Taken</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>------------------</td>
<td>-------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>5. Spalding Gas</td>
<td>Central Georgia Electric Cooperative</td>
<td>Rebates &amp; kickbacks to customers who convert from gas to electric heat.</td>
<td>Sent letters to Congressmen.</td>
</tr>
<tr>
<td>415 W. Solomon St.</td>
<td></td>
<td>Deceptive Advertising.</td>
<td>Joined the Georgia Propane Gas Association, Inc. (Georgia Propane), which acted as an intervenor in a proceeding before the Georgia Public Service Commission (PSC) (Docket No. 3618-U). Georgia Propane argued in support of the regulation of promotional practices of all utilities within the State of Georgia, including electric membership corporations (EMCs). The Georgia PSC has not issued its final order in this Docket.</td>
</tr>
<tr>
<td>Griffin, Georgia 30223</td>
<td></td>
<td></td>
<td>Sent letter to Congressman</td>
</tr>
<tr>
<td>6. Blue Flame LP Gas</td>
<td>Wabash County Farm Bureau</td>
<td>Unfair practices such as hiring Blue Flame's employees and soliciting Blue Flame's customer list.</td>
<td>Sent letter to Congressman Dan Coats, who sent a return letter acknowledging that he had received the letter.</td>
</tr>
<tr>
<td>Box 237</td>
<td></td>
<td>Offering low cost electric water heaters, electric pumps, etc. to customers who convert from gas to electric.</td>
<td>Went to Washington to lobby for changes in REA policy regarding financing.</td>
</tr>
<tr>
<td>North Manchester, IN 46962</td>
<td></td>
<td>Wabash County also entered the propane gas business, offering propane at $1.10 to $1.15 per gallon cheaper than Mr. Leon Retenour could profitably offer it for.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Deceptive Advertising.</td>
<td>Sent letter to Congressman, who sent a letter acknowledging receipt of original letter.</td>
</tr>
<tr>
<td>7. Siouxland Propane Co.</td>
<td>R.E.C.</td>
<td>Offering electric water heaters for $1 if customers replace their gas water heater.</td>
<td>Complained through NLPGA.</td>
</tr>
<tr>
<td>Box 188</td>
<td>415 8th St. SE</td>
<td>Free installation of electrical wiring to customers who replace any type of gas heating with electric.</td>
<td></td>
</tr>
<tr>
<td>Ireton, Iowa 51027</td>
<td>Orange City, Iowa</td>
<td>Deceptive Advertising.</td>
<td></td>
</tr>
</tbody>
</table>
Alabama: None
Alaska: None
Arizona: None
Arkansas: Name: Arkansas Electric Cooperative

Problem:
Installed and maintained dusk-to-dawn outdoor security lighting in public facilities.

Action undertaken: None

California: None
Colorado: None
Connecticut: None
Delaware: None
District of Columbia: None
Florida: None
Georgia: Name: Walton EMC

(The following information was provided to SVL by Mr. Walter Boss, NECA state chapter manager, Atlanta, Georgia, on November 22, 1988.)

Name: Walton EMC

Problems:
Offer installation of free outdoor electrical lighting equipment to various baseball and football fields if Walton is chosen to supply the electricity. Walton's work crews are utilized to install poles and lighting fixtures.

Action undertaken: None

Hawaii: None
Idaho: None
Illinois: Name: South Illinois Electric Cooperative

Problems:
Engaged in competitive contracting, installation of wiring and distribution equipment and load control equipment on customer premises, installation of...
submetering equipment, material and equipment sales, performing commercial energy audits, providing design assistance to large accounts, maintaining a prequalified contractor list, installation of dawn-to-dusk outdoor security lighting, installation of street lighting, labor brokering, electrical wholesaling and equipment maintenance.

Action undertaken: None

Indiana: None
Iowa: None
Kansas: Name: Kaw Valley Electric Cooperative

Problems:
Engaged in competitive contracting, involving supply and installation of electric hot water heaters, installation of dusk-to-dawn lighting, installation of direct load control equipment, labor brokering and electrical equipment maintenance.

Action undertaken: Negotiations with utilities

(The following information was provided to SVL by Mr. Ken Pellegrino, NECA state chapter manager, Topeka, Kansas, on November 1, 1988, and Mr. Johnny Jones, President, Jones Electric, in an informal communication on November 23, 1988.)

Name: Ark Valley Electric, Centel Electric

Problems:
Competes with electrical contractors for outdoor security lighting, both commercial and residential. Lighting fixtures are sometimes attached to existing poles, which allows REC to simply charge more on customers monthly bill.

Action undertaken: None

Kentucky: None
Louisiana: None
Maine: None
Maryland: None
Massachusetts: None
Michigan: None
Minnesota: Name: Dakota Electric Association

Problems:
Installed outdoor security lighting in thirteen parks located in the city Burnsville.
Action undertaken: Informal complaints to the Public Utilities Commission

PUC response: Sent letter to Tom McKernon, NECA manager, St. Paul, Minnesota, which stated that under the "Minnesota Electric Act," cooperatives are allowed to install lights on their own transmission poles. However, it is illegal for cooperatives to install lighting in all areas not accessed by their own transmission lines.

Mississippi: Name: East Mississippi Electric Power Association

Problems: Installs wiring directly up to mobile home trailers. Maintains a prequalified contractor list for installation work and provides design assistance to large accounts.

Action undertaken: None

Missouri: None
Montana: None
Nebraska: None
Nevada: None
New Hampshire: None
New Jersey: None
New Mexico: None
New York: None
North Carolina: None
North Dakota: None
Ohio: None
Oklahoma: None
Oregon: None
Pennsylvania: None
Rhode Island: None
South Carolina: None
South Dakota: None
Tennessee: None
Texas: None
Utah: None
Vermont: None
Virginia: None
Washington: None
West Virginia: None
Wisconsin: None
Wyoming: Name: Big Horn Electric Cooperative

Problems: Competes with electrical contractors for construction work in commercial buildings, campgrounds and other public facilities.
Action undertaken:
Informal complaint to Public Service Commission

PSC response:
Stated in a letter to Ron Cooper, Wyoming NECA state chapter manager, that their only course of action would be to provide the complaint to a public intervenor when a rate case arises, thereby reducing the opportunity for cross-subsidization between regulated and non-regulated businesses.
Sources


Honorable Jim Bates
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Bates:

I commend your foresight and leadership in sponsoring Rural Electrification Administration (REA) reform legislation. The bill would prevent the financial insolvency of the REA's revolving fund, reduce the subsidized REA lending programs' extremely high costs to the U.S. taxpayer, and help ensure that REA borrowers will not have an unfair competitive advantage against nonsubsidized taxpaying businesses.

If we are able to enact reform legislation now, you will save the taxpayers hundreds of millions of dollars, but at the same time, continue REA lending program assistance in a lower cost form to borrowers serving rural areas. Your bill, the Rural Electrification Administration Lending Assistance Improvements Act includes reforms that closely parallel those proposed by the Administration.

Congratulations on your foresight, courage, and leadership on this important matter. If I can be of assistance, please call me.

Sincerely yours,

James C. Miller III
Director

IDENTICAL LETTER SENT TO HONORABLE JOSEPH DioGuardI
Today a bill was introduced in the House of Representatives to reform the Rural Electrification Administration. The legislation, called "The Rural Electrification Administration Lending Assistance Improvements Act of 1988," was sponsored by Reps. Jim Bates (D-Calif.) and Joseph DioGuardi (R-N.Y.) with bipartisan cosponsorship.

Reps. Bates and DioGuardi deserve commendation for their legislative initiative on deficit reduction without harming rural farm interests or abolishing REA. Their bill saves taxpayers nearly $5 billion over the next five years while preserving a federal role in ensuring quality utility service to rural America.

The bill replaces REA's direct lending program with federally-backed guarantees of private sector loans. In addition, it discontinues making loans to metropolitan-type borrowers and multi-million dollar telephone holding companies and provides a safety net program of below-market federal loans to borrowers in financial hardship.

The agency would also be given authority to revitalize its successful direct loan prepayment program which sunset in 1987.
CONGRESSMAN JIM BATES INTRODUCES BILL TO REFORM REA LOAN PROGRAM

Washington -- Today Congressman Jim Bates (D-CA), along with Congressman Joseph DioGuardi (R-NY), introduced a bill in Congress to reform the Rural Electrification Administration's loan program. The purpose of the bill is to correct inequities in the current REA loan program while reducing the federal budget deficit by $5 billion over the next 5 years.

Congressman Bates' legislation, known as "The Rural Electrification Administration Lending Assistance Improvement Act of 1988" would replace high-subsidy REA direct loans with loan guarantees when assisting legitimate rural borrowers. The legislation, however, ensures that borrowers in true need get direct, high-subsidy assistance. The Office of Management and Budget, in conjunction with the Department of Agriculture and the Rural Electrification Administration, reported that the impact of the legislation on the typical ratepayer would be 74 cents per month.

The need for the legislation was generated because of the increasing awareness that many recipients of the REA loans are not in need of those loans. "Ski resorts, tanning centers, and many urban areas, which in a recent 6 year span received 20% of all electric loans aimed at rural areas, have been abusing the original intent of the program which was enacted back in 1936" said Bates at a press conference to announce the introduction of this bill.

Bates also pointed out that while the national average for residential electricity services is $80.43 for 1,000 kilowatts/month, the average paid by REA recipients is only $73.63. The average for residents of San Diego County is $105.95.

Bates attributed much of the blame for the continuance of the extravagant subsidies on "Will Rogers Congressmen -- those who never met a spending bill they didn't like".

The bill has received bipartisan support as well as endorsement by the Reagan Administration and various coalition groups.

"This legislation", said Bates, "can reform the program, and reduce our costs without harming rural America or abolishing REA. It allows us, in a substantial way, to find the resources to meet other urgent needs of today's America."
WASHINGTON - Declaring that such places as Hilton Head, North Carolina, and Aspen and Vail, Colorado are no longer the rural and needy places they used to be, Congressmen Joe DioGuardi (R-NY) and Jim Bates (D-CA) today introduced legislation to curb taxpayer subsidized loans by the Rural Electrification Administration.

Created as part of the New Deal in 1936, the REA's purpose was to ensure that remote regions of rural America were not denied electricity because of their location. However, the REA still provides taxpayer subsidized power to such resort communities as Hilton Head, Vail and Aspen, in addition to other non-rural communities.

"Our legislation," DioGuardi said, "seeks to bring the REA into the 80s. There is no sensible reason that a Federal agency should run today along the same lines as when it was originally founded fifty years ago. It is time to save the taxpayers money and bring the REA up to date."

The legislation, which would reform REA by replacing the current high subsidy direct loan program with a guarantee program, will result in an annual $1 billion savings to the taxpayers. The legislation will also end government subsidies to areas that were rural in the 40s, but are now urban or suburban.

DioGuardi also pointed out that the national average for residential electricity services is $80.43 for 1000 kilowatts/month, while the average paid by REA customers is $73.63. The average for residents of New York state is $106.35 and $117.69 for Westchester County.

"There is no reason to continue this old, worn out, and unfair subsidy," DioGuardi said. "Wealthy utilities are making mints of money from this corporate welfare program. We seek to put an end to this abuse of the treasury."
(WASHINGTON, D.C., JULY 13, 1988) -- The National Taxpayers Union today threw its support behind legislation to reform outmoded Rural Electric Administration (REA) loan programs. NTU praised Representatives Jim Bates (D-CA) and Joseph DioGuardi (R-NY) for introduction of "The Rural Electrification Administration Lending Assistance Improvement Act of 1988." If approved, this measure could reduce budget outlays by $2.3 billion in Fiscal Year 1989 and $1.0 billion annually thereafter.

Since start-up in 1935, the Rural Electrification Act's loan program has achieved tremendous success in delivering electric and telephone services to rural America. Today nearly 99 percent of rural homes have electricity, 96 percent have telephones and rates paid by rural customers are competitive with suburban/urban buyers.

However, despite this success and the financial security of most REA borrower-providers, another goal of scaling back dependence on government subsidized credits and increasing use of private credit markets has not been achieved. Since 1973, taxpayer subsidies of REA borrower interest rates has amounted to $50 billion. In fiscal year 1988 REA has $36 billion in outstanding loans with an additional $7.6 billion approved, but not advanced, for direct loans.

NTU Director of Government Relations, Sheila Macdonald, noted that "Because of highly favorable interest rates, non-rural interests have found ways to attach themselves to REA programs. They have been drawn, as if by magnets, to two and five percent loan rates." Non-rural interests include suburban and urban customers, giant telephone holding companies and posh resorts.

The Bates-DioGuardi legislation would change all this. It would end subsidies to borrowers servicing non-rural and resort areas. It would also prohibit private telephone holding companies from benefitting from low interest loans. In addition, current five percent interest rates would be replaced by partial government loan guarantees (70-80%) for private credit. The rural telephone bank would be privatized by 1995.

NTU favors reform of all government-wide credit programs and sees the Bates-DioGuardi bill as an excellent step in the right direction. Macdonald commented that "The main question today is whether Congress, which has become efficient at setting up programs, has the courage to pare back now that a 'mission has been accomplished?' With budget deficits bursting beyond Gramm-Rudman-Hollings limits and the nation's debt at $2.5 trillion, members of Congress should take this opportunity to hold hearings and enact this legislation before the 100th Congress adjourns," she stated.

The National Taxpayers Union is a nonprofit, nonpartisan group representing more than 150,000 taxpayers in all fifty states.
APPENDIX E
H. "Safety" means a practice or device intended to reduce the likelihood of personal injury for property loss.

.02 Prohibited Promotional Practices.

A public utility or its affiliate may not engage, directly or indirectly, in any of the following promotional practices:

A. Financing land or the construction of a building when it is not owned or otherwise possessed by the utility or its affiliate;

B. Furnishing consideration to a person for work done or to be done on property not owned or otherwise possessed by the utility or its affiliate, except for studies to determine comparative capital or operating costs and expenses or to show the desirability or feasibility of selecting one form of energy over another;

C. Acquiring from any person any tangible or intangible property or service for a consideration in excess of its value or furnishing any person any tangible or intangible property or service for a consideration of less than its value;

D. Furnishing consideration to a person directly or indirectly or through a third party which draws any monetary support from a regulated utility to influence the sale, installation, purchase, or use of any appliances or equipment;

E. Providing free, or at less than cost or value, wiring, piping, appliances, or equipment to a person; provided that a utility, engaged in an appliance merchandising sales program, is not to be precluded from conducting legitimate close-outs of appliances, clearance sales, or sales of damaged or returned appliances;

F. Providing free, or at less than cost or value, installation, repair, modification, or maintenance of appliances or equipment, wiring or piping to any person;

G. Granting a trade-in allowance on the purchase of any appliance or equipment in excess of the value of the trade-in, or granting a trade-in allowance for the appliance or equipment when the allowance varies by the type of energy consumed in the trade-in;

H. Extending credit to finance the acquisition of any appliance or equipment at a lower rate of interest or under more favorable payment terms (but excluding those applicable to default) than those generally applicable to sales by non-utility dealers in appliances or equipment;
IV. B. CASE STUDIES
CASE STUDY

ABLE COMMUNICATIONS, INC. VERSUS
THE SOUTH CAROLINA PUBLIC SERVICE COMMISSION
AND
FARMERS TELEPHONE COOPERATIVE, INC.
ABLE COMMUNICATIONS, INC. VERSUS
THE SOUTH CAROLINA PUBLIC SERVICE COMMISSION AND
FARMERS TELEPHONE COOPERATIVE, INC.

Able Communications, Inc. (Able), a Radio Common Carrier (RCC) in South Carolina, filed suit against the South Carolina Public Service Commission (PSC) and Farmers Telephone Cooperative, Inc. (Farmers). The petitioner, Able, sought to have the PSC orders of May 16, 1984, and June 18, 1984, (Order Numbers 84-419 and 84-508 arising out of Docket Number 83-436-C) approving certain rates and tariffs for voice and tone paging services offered by Farmers reversed and remanded. The arguments were heard in the Court of Common Pleas for the Fifth Judicial Circuit. After an order dismissing the appeal seeking judicial review by that court, Able appealed to the state's Supreme Court. There the PSC order of May 16, 1984, was vacated and the matter remanded to the PSC. Since that time, Able was bought out by another company and the new owners have chosen not to pursue this matter with the PSC.

Background:

Farmers is a certificated telephone cooperative doing business in five counties of South Carolina. As a Rural Telephone Cooperative, Farmers' certificated areas did not include the municipalities within these counties prior to 1984. Farmers' telephone franchise allows it to provide any kind of telephone or RCC service within its certificated areas. The company has provided land line telephone service since 1953. Additionally, Farmers has been offering mobile telephone service since 1964 and tone paging service since 1977. At the time of the PSC hearings central to this case, in 1984, Farmers served approximately 27,000 land line customers.

Able is the holder of a certificate of convenience and necessity to provide RCC services in ten South Carolina counties, including the municipalities contained therein. The five counties in which Farmers operates are among these ten. Able's rates and tariffs have been approved by the PSC. Able had approximately 1,500 paging customers, with 450 pagers, in Farmers' service area at the time of these PSC proceedings in 1984. Also, Able was serving about 1,000 customers who were in areas where no paging services were offered by any other certificated and regulated company. The PSC had previously determined that a tariff of $41 per month for tone and voice paging furnished by Able was just and reasonable.

On August 26, 1983, Farmers filed with the PSC for approval of a tariff to amend its existing tone-only paging tariff, to provide for rates and charges for a new service, voice and tone paging. The proposed tariff for this service was $27 per month. Able filed a Petition to Intervene in the proceeding. Later, the
Consumer Advocate for the State of South Carolina filed a Petition to Intervene Out of Time. Both parties were permitted to participate as Intervenors in the tariff proceeding.

In the process of prehearing discovery, Able learned that Farmers was providing RCC services to customers in municipalities outside Farmers' certificated territory and within Able's territory. Able then, on January 24, 1984, filed a petition before the PSC requesting a cease and desist order barring Farmers from offering its paging and mobile telephone services in all municipalities where it was uncertificated to do so. The cease and desist matter was combined with the tariff request and both issues were heard by the PSC on February 13 and 14, 1984.

PSC Proceedings, Docket No. 83-436-C:

Farmers' counsel noted that the company was at that time offering tone-only paging service and requested that the PSC approve a tariff filing for tone and voice paging within its certificated area. He said that Farmers admitted serving paging customers outside its approved areas in certain municipalities surrounded by its certificated areas and that it had done so for about ten years. He explained that Farmers had filed an application for a certificate for these areas and proposed that the cease and desist order requested by the Intervenors be merged with the docket addressing that certificate application.

Counsels for each of the Intervenors first briefly mentioned the cease and desist order request and their willingness to have that matter combined with the current tariff hearing. They then went on to express their central concerns that the tariff Farmers applied for was non-compensatory and, if approved, would require cross-subsidies from Farmers' other customers.

The PSC then announced its decision to hear testimony relating to both issues. All testimony about the paging tariff applied for and about the cease and desist request was welcomed.

Three officers testified for Farmers. Their testimony pertained to the operation and coverage of the proposed tone and voice paging system and to the rate study Farmers had prepared for the new service.

It was stated that three of Farmers' four transmission towers were located outside Farmers' certificated areas and within those of General Telephone. Officers said that the application Farmers had filed with the Federal Communications Commission (FCC) for the tone and voice paging system proposal had been prepared by an outside engineering firm. They agreed that the cost of that study, which was done strictly related to tone and voice paging, should be recovered in the rate charged for that service. It was also
acknowledged that the transmitters would use electric power provided by local utilities, but that a figure for this cost was not included in Farmers' rate study.

Forecasted subscriber levels for the new service were stated to have been determined through the use of a mailed survey, personal contacts, and historical data related to tone-only paging experience. Rates of $24, $22, and $20 per month for one pager, two to five pagers, and over five pagers respectively, on Farmers' original application for tone and voice paging services with the FCC were said to have been subjective rates provided at the last minute. It was acknowledged that Farmers did not make its rate study until after Able had intervened in this tariff filing. The $26 rate on the application to the PSC was explained as based on subjective determination as well. The $2 increase was attributed to increased general knowledge of the system since the time of the earlier application.

When Farmers conducted its rate study, the appropriate rate was determined to be $26.50. The $27 rate now supplied was explained to be due to a change in the tower lease amount based on year-end figures which differed from projections. It was then orally requested that the tariff proposed be amended to $27 to conform to the cost study.

A projection of 195 customers for the new service had been used on Farmers' FCC filing, but the current projection was 250 subscribers. It was confessed that approximately 50 percent of the company's current paging customers resided outside of Farmers' approved service area.

It was agreed that a $1.40 tariff item for the coaxial cable loop from antenna to transmitter should not be there because this cable was put up by Motorola as part of a $74,000 contract which was addressed under depreciation expenses. Another $1.40 per month charge for the loop from transmitter to central office was for an underground cable which did not involve any current construction cost because this cable was previously placed and used for other purposes. Also, the $49.50 rate for the central office trunk line did not involve any mileage consideration.

It was again acknowledged that 50 percent of those subscribing to this service lived outside Farmers' approved territory and that the projection for the new service involved an assumption that some percentage of those 250 subscribers would be outside the service area. It was also conceded that when the projection was made, there was no allowance made for cancellations among projected subscribers.

When asked about Able's attempts to get a quote from Farmers on paging numbers, Farmers' marketing manager said that Able had been requesting this service for several months. He stated that
although Farmers had been providing those paging numbers to itself since beginning to offer RCC services, Farmers did not have an approved tariff for offering this service to others. He said it had filed for one, though, and that the rates would be comparable to those used in the cost study. He conceded that he did not know what the actual cost of providing these numbers was and that the $19.25 figure on the rate study was arrived at by asking Southern Bell what they charge.

Then when asked by the attorney for the Consumer Advocate's office whether Farmers had developed its rates or its cost study first, he responded, "We developed our cost study. We developed the initial rates and then we did a cost study." He acknowledged also that the survey used for forecasting the number of pagers was not based on a statistically random sample.

Farmers' comptroller, the firm's final witness, presented the cooperative's rate study. He stated that a $26 tariff had been filed with the PSC for voice paging. When Able subsequently intervened, the company was advised that a rate study would most likely be required. He described the rate study process as follows:

"We identified all the telephone facilities used in offering voice paging. Then the actual cost of the paging investment was determined from the contract on voice paging equipment. Marketing submitted the number of pagers forecasted to determine investment in paging units. The next step was to calculate the operating expenses. Then the rate base had to be determined. After determining the rate base, the rate of return was determined. With the operating expenses and return on investment calculated, the revenue requirement was determined. After determining the revenue requirements, the actual rates were determined using the forecasted paging subscribers."

Exhibits were offered showing the expense and revenue figures calculated. The comptroller stated that the rates determined were $27 for single voice pagers, $25 for two to five voice pagers, and $23 for over five pagers. The study had not included costs for electric power to generate the transmitters nor had some $5,900 of engineering costs related to the FCC filing been capitalized and used in the study. He was asked to make calculations to include these costs and report the results the next morning.

The method of expense allocation used in calculations was explained. The comptroller said he took 1984 forecasted telephone expenses and used 1983 projected telephone revenues as a divisor. The percentage that calculation gave was used, along with an estimation of paging revenue, to arrive at an allocation of paging expenses for commercial, general office, other operating, and
operating taxes, as well as depreciation for building, office furniture and equipment. He said this method was used because identifiable costs were not available for these items.

Actual costs were used for the contract with Motorola and for the individual cost of pagers multiplied by the projected number of these. The comptroller explained that an adjustment was made in the expense allocation calculations to exclude from 1984 expenses certain directory costs, operating rents and expenses related to a cost study for separation purposes. He said that these costs would have been included in the leased telephone facilities calculations.

Another method was used to calculate projected maintenance expense. The comptroller said this was done because there are leased telephone facilities and maintenance costs for these are included in the lease. A figure of 3.66 percent of central office equipment investment was arrived at for maintenance expenses. The percentage was found using 1982 cost figures. If 1983 figures had been used the percentage would have been 3.68 instead of 3.66 for a difference of about $17 for the year.

It was stated that general office salaries and expenses allocated should cover the law department. Actual legal fees for services in this proceeding were not included, but the allocation method used to arrive at a general office expense of $6,376 would allow for approximately $95 of legal expenses.

Using figures from the rate study, Able's attorney, with guidance from Farmers' comptroller, came up with a figure of $13,740 as the maximum possible salary expenditure.

The hearing was adjourned for the evening. When it resumed the next morning, the comptroller presented his recalculation of rates to cover the $5,900 of engineering costs and the power costs. He stated that a figure of $80 was used for power costs for the transmitters; for the terminal, half of a $50 charge was allocated. This amounted to $1260 for yearly power costs. Including this and the engineering costs led to a $28.11 single voice paging rate element instead of the previous $27. This was stated to be a cost figure, not the rate being suggested.

He was then questioned about the L forms Farmers had filed with the FCC on its tone-only paging and mobile telephone services for the years 1978 through 1980. The 1980 form showed 68 pagers and 97 mobiles in service. It showed one full-time and three part-time employees. Salary expenses were $31,700.25 and, with revenues of $70,983.50, losses were recorded as $32,314.16. The 1979 form listed 81 pagers and 88 mobiles, and salaries of $49,706.80. It showed three full-time and six part-time employees. This form showed revenues of approximately $69,000 and losses of over $7,500. On the 1978 form, the numbers were 71 pagers and 119 mobiles in
service, with salaries of $35,678.61. It showed three full-time and six part-time employees, revenue of $66,399.61 and a loss of $5,132.39.

Overall, these figures were seen to represent salary expenses of 50.8 percent, 64.68 percent, and 49.8 percent of total expenses for 1978, 1979, and 1980, respectively. Farmers' comptroller was then asked how salaries of at most $13,740 could be used to produce almost $80,000 of revenue given these past experience figures. He said there would be no additional employees for voice paging and that the figures were arrived at through the allocation process.

When asked whether Farmers was required to file L forms with the FCC after 1980, he stated that the forms were not required. The comptroller further declared that he could not state whether Farmers had made or lost money on its tone-only paging and mobile telephones in 1981, 1982, and 1983 because those expenses were not broken out separately in the company's books. Asked whether he could swear that if the commission approved $27 or $28 for the rate, that then not one penny would be subsidized by Farmers' land line customers, he said he could not.

The comptroller handled questions about the times interest earned ratio (TIER). He explained that it's a term the REA uses in considering loans. If the TIER is 1.5 or less, then the cooperative could qualify for a 5 percent loan, but if the TIER is greater than 1.5, the borrower must seek a bank loan at a high interest rate. He stated that Farmers' TIER had been below 1.5 for the past few years. He agreed that Farmers' current capital structure was about 92 percent debt and 8 percent equity capital.

When asked if Farmers could set up accounting procedures to prove to the PSC in six months or a year whether Farmers had made or lost money on its tone and voice paging service if required, he stated that it would have to. When asked whether he intended to institute any procedures or controls to find out whether money was made or lost, with or without a commission order to do so, the comptroller said yes. He did acknowledge, though, that he had not done anything from 1982 up to that time to determine what it would cost Farmers to provide this service.

It was pointed out that, although the depreciation factor used for central office equipment in the study was 10 percent, an annual report filed as of December 31, 1982, showed a 14.3 percent depreciation rate. The comptroller said 14.3 percent was a composite rate for all central office equipment which included different rates for equipment related to different services.

Able's first witness was the president of a utility financial, economic and rate consulting firm. He said he would testify, on behalf of Able, as to the proper revenue requirements and rate design for the voice and tone paging service proposed.

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This consultant explained that the two primary components of revenue requirements are expenses and capital costs. He had relied upon an analysis prepared by David Thomy of Able for Farmers' proper expenses and had developed his own estimate of required capital costs or income for return. He said he did not use the expense figures Farmers had developed because "they had no factual basis." He felt Mr. Thomy's estimates were more realistic since they were based on years of experience providing similar service to similar customers. He suggested that, at the proposed rates, Farmers' rate of return would be negative 7.02 percent.

His approach to calculating necessary income for return was based on the TIER. He stated that the REA and Rural Telephone Bank had found that they were able to raise capital if member-borrowers maintained a TIER of 1.5. Using a TIER of 1.5, he computed the necessary rate of return on rate base.

The consultant noted that Farmers had a capital structure of 92 percent debt and 8 percent equity. He found the weighted embedded cost of debt to be 4.56 percent and with a TIER of 1.5, the necessary rate of return was 6.84 percent. The resulting return on equity was 28.34 percent. This was the rate of return he used to generate required income. He used equity return, not the overall cost of capital of 6.84 percent, because Farmers' comptroller had stated that no REA money was or would be received for these items and that pager system investments were not financed with debt.

The consultant found that revenue requirements for Farmers were $128,671.39. The rates which result from this requirement were stated to be $44.50 per month for 1 pager, $42.50 for 2 to 5 pagers, and $40.50 for more than 5 pagers. He further noted that if pagers were customer owned and maintained, then Farmers would save approximately $11.50 per month per pager and computed rates could be adjusted accordingly. It was his opinion that if the PSC approved rates lower than those he calculated, then telephone subscribers would be subsidizing Farmers' voice and tone paging.

He acknowledged that several expense items were calculated, by Mr. Thomy, to be different from those in Farmers' study. When asked specifically about the number group lease figure, he stated it to be $121.45 as opposed to $19.25 in Farmers' cost study. The next item questioned was the expense for tower leases. His figures showed $112.71 per month while the study by Farmers had $45. Again the consultant stated that he had not done these calculations but that this figure was an average of all the tower rentals that Able had in the area.

The consultant was asked to read from a copy of the PSC's order for Farmers' last rate case, issued in December 1982. The number for rate of return on rate base was 3.63 percent.
Nonetheless, he reiterated that since the paging service would be entirely equity financed, the rate of return on the paging rate base should be 28.34 percent. He admitted that 28 percent looked very high, but he insisted that this was due to the very small number of dollars to which the equity return was related.

The next two witnesses for Able were businessmen in the community who had used Farmers' services. They told of various problems they had experienced and expressed some frustration with the cooperative over its handling of these matters.

David Thomy, Secretary and Treasurer of Able Communications, Inc., was then called as the final witness for Able. He was asked about Able's certificated areas and about those of Farmers. He said that although Farmers' territory included some counties Able served, Farmers' certificate excluded certain municipalities within those counties. He stated that Able had approximately 1,500 paging customers overall. Of these, Able had 454 pagers within Farmers' service areas.

Able charged $41 for wide area service and equipment and $30.50 for local service and equipment within Farmers' service area. For another wide area service which was partly in Farmers' area, Able charged $46 because it covered a larger area. Mr. Thomy acknowledged that these rates were approved by the PSC. He compared these to Farmers' proposed rates as follows: Farmers proposed a $27 rate for wide area or local service as compared to Able's rates of $41 and $30.50, respectively. Farmers proposed a $16 rate for service only as compared to Able's rates of $28.50 and $18 for service only.

Mr. Thomy said Farmers' rate study projected a rate of return of 10 percent. He characterized this as unrealistic. When asked what rate of return Able had achieved, using the same formula Farmers had used in its rate study, for the year from April 1, 1982, to March 31, 1983, covered by its most recent annual report, he responded 12.5 percent.

Mr. Thomy was then asked about the changes he recommended in figures in Farmers' study. He advised a change in the breakdown of numbers of pagers. He stated that, at Able, 38 percent of customers use only one pager, 42 percent use between two and five, and 20 percent use over five pagers. If these percentages were substituted for those in Farmers' study, total annual revenue given the proposed rates would be reduced to $76,080 from $78,276.

Mr. Thomy said Farmers was depreciating its new paging investment and the portion of existing terminal equipment allocated to this service over a 10-year period, while using a 5-year period for its pager investment. He noted that in Farmers' 1982 annual PSC report it had used a 7-year life to depreciate central office equipment. By computing depreciation on its transmitter and
terminal equipment for 7 years rather than 10, he calculated additional depreciation of $3,526.55.

He also spoke of inconsistencies in Farmers' method of allocating costs. He found most expenses were computed by using ratios of total expenses to total revenues. Maintenance expense, however, was calculated using a ratio of central office repairs to central office equipment. Also, this figure was based on 1982 data while all other allocations were based on 1984 adjusted expenses. Using the ratio of total maintenance to total revenue to allocate maintenance expense, he got 26 percent, for a dollar figure of $20,800. This was compared to a 3.66 percent ratio for a maintenance expense of $3,009 according to Farmers' study. He also said that Farmers had painted a tower for a cost of approximately $5,000 and would probably need to paint one tower per year. He felt an allocation of only $3,009 to be too small.

Mr. Thomy further stated that Farmers' expense for paging numbers, called Direct Inward Dial or DID numbers, was "completely off base." He said Able was paying General Telephone $121.45 plus tax for 100 numbers as opposed to the $19.25 used in Farmers' study. He noted that Able had been asking Farmers to make DID numbers available and requesting a rate for them for three years. He did not believe there was any relation between Southern Bell's rate and Farmers' cost to provide these numbers.

Of the $45 listed for tower leasing at each location, Mr. Thomy said this was too low. He noted that Able paid an average of $112.71 for tower leases at the ten sites in its system. He also said Able paid power costs of $17 per month at a low powered base station and $25 at a high powered station comparable to the ones Farmers had. He suggested, as a conservative estimate, $20 per month for each of the cooperative's four transmitters.

Mr. Thomy also questioned the building lease figures. He said Farmers used $2 per square foot and a space of 4' x 4' except in one office where two such spaces were projected. He expressed doubts about this being enough space.

Then he was asked to comment on the impact an approval of Farmers' proposed rates would have on Able. Mr. Thomy suggested that ultimately Able would be forced to reduce its rates in some areas to match those of Farmers and that where Able could not reduce rates it would lose all its customers. This would lead to such losses that Able would have to go out of business. He stated that over 1,000 of Able's present customers were outside of Farmers' service area and that there were no other certified RCC services available in these areas.

When asked about his businesses, Mr. Thomy acknowledged that he had mobile telephone and paging services and an answering service. He also contracted with another answering service. He
said he paid both the answering services $500 per month. He did not know how much other RCC's paid for answering services. He said he felt the best way to allocate this cost was to base it on the contract with the answering service which was not owned. He was asked how the owned answering service, which provides service to others as well, had determined that the costs to operate this system were $500. He said costs were allocated based on what is being done and whether it could be done within the allocation. He said that since the other answering service was doing the same job at the same time over possibly the same number of mobiles, this was seen as the best way to determine that expense.

The questioning then turned to the major differences between Mr. Thomy's calculations and those of the rate study by Farmers. These were acknowledged to be the paging numbers, the tower lease, the circuits to Sumter, and the $1.40 monthly antenna to transmitter fees. Mr. Thomy did concede that this $1.40 per month was part of a total annual expense of over $63,000.

Mr. Thomy was asked about the costs for paging numbers. Farmers said these should be $19.25 and he said they should be $121.45. When asked what he paid Southern Bell in Florence for this item, he responded $19.25. When asked what he paid G.T.E., he answered $121.45. He accepted subject to check that Farmers had filed for a tariff of $19.25 with the PSC for this service, but he would not agree that this was its cost. When asked about G.T.E.'s and Southern Bell's costs, he stated he did not know them.

The next subject was the circuits to Sumter. Mr. Thomy agreed that two circuits were needed, one in each direction. He assumed that a dedicated line would also be needed to answer any questions or problems with the line. He acknowledged, however, that companies do not always have dedicated lines for this.

The discussion then focussed on the tower lease figures. Farmers said those costs were $45 and Mr. Thomy said they should be $112.71 based on the average of all of Able's towers. He asserted that Farmers had not stated in any manner how this cost figure had been determined.

Mr. Thomy also spoke about the use of a 7-year depreciation period instead of a 10-year one. His argument was that the useful life over which to depreciate this equipment was seven years. He asserted that this was the figure generally used by RCCs. He did acknowledge, however, that the costs of different RCCs in South Carolina vary and that those of several were lower than Able's. He accepted subject to check that there was only one other carrier in the state with a higher rate than Able's.

Mr. Thomy said he would want the commission to set rates for Farmers according to its costs. He stated that where these costs were not shown, though, Able's rates offered a real-world test.
He insisted that if the PSC set an interim rate in Farmers' favor, he would lose customers and not be able to get them back.

When asked the rate of return on equity implicit in Able's overall 12.5 percent return, Mr. Thomy said he did not know. He stated that he used basically the same equipment as Farmers including Motorola transmitters but that the model numbers might differ. He also said that if his customers wanted to, they could terminate service immediately, with no advance notice, and receive a refund for any fees paid in advance.

Finally, Mr. Thomy was asked what would happen if the PSC approved Farmers' proposed tariff but refused to grant it a certificate for cities Able was already serving. He said that Able might then manage to keep some of its customers but would lose their respect because they would think Able was gouging them. He also acknowledged the possibility that some might use an alternate address of someone who lived out of town.

Able's counsel then summarized with its argument that a cease and desist order should be granted. He also claimed that Farmers did not know what its service had cost in the past and would not know its costs in the future for this new service. He stated that Farmers had not met its burden of proof of a fair and reasonable rate.

Farmers' counsel reiterated its request that the PSC not issue a cease and desist order but carry the matter over until the certificate case would be heard. He then acknowledged that Farmers' cost study was based on allocations, but he defended this as a reasonable approach. He suggested that the major differences between costs proposed by Able and those proposed by Farmers were a matter of choice of methodology and that Able was being unreasonable in insisting that Farmers use its methods. He stated that the final figure the comptroller had presented, $28.11, was Farmers' cost. The hearings were then concluded.

Three months after the completion of these proceedings, on May 16, 1984, the PSC issued Order Number 84-419. This fifteen-page order recounts the matter under consideration, filings of all parties to the proceedings, names of all witnesses and a brief summary of testimony heard. This is followed by a section entitled "Discussion and Conclusions," which relates how the commission has carefully considered each side's views. Farmers is then found to have met the burden of showing that the proposed tariff is reasonable and fair based on its operations. Farmers is also found to be offering paging and mobile telephone service in municipalities in which it is not certificated and, therefore, the PSC should issue a cease and desist order for these areas except for ones where Able is not equipped to provide similar services. In addition, the PSC finds that Farmers should keep records sufficient to show earnings on its respective telephone operations.
These orders are specified on the final page of the document: the approval of the tariff filing, the cease and desist order, an order that Able inform the commission when it is prepared to provide full RCC services in certain areas at which time Farmers will cease and desist providing services there, and an order that Farmers "maintain sufficient records to show earnings on its telephone operations and earnings on its paging operations."

This order led Able to file a petition for rehearing, oral argument and/or reconsideration. Able's petition asked for reversal of the order or, alternatively, for a supplemental hearing taking additional testimony and/or permitting additional oral argument. The petition proposed that the PSC erred in finding the proposed tariff fair and reasonable. It further suggested that approving the $27 rate was an error because a higher rate was submitted verbally during the hearings to include certain previously omitted costs and if any rate submitted should be approved, it should at least be that higher rate. The petition also found fault with the commission staff because they filed no motions, took no depositions, and asked no questions at the hearing. The accounting staff, it pointed out, made no presentation to the commission. It also alleged error in the failure to consider the economic impact of this decision on Able.

The Consumer Advocate also filed a petition for rehearing and reconsideration of the order. This petition noted that the order failed to provide sufficient findings of fact and conclusions of law, separately stated, to support the approval of the proposed tariff. It asserted that the approved tariffs do not appear to be compensatory or based on substantial evidence.

On June 18, 1984, the PSC issued Order Number 84-508 denying the petitions for rehearing and reconsideration. The commission found the petitions to be without merit. The order further noted that a hearing was scheduled for July 12, 1984, under Docket Number 84-135-C, which might render the cease and desist order previously issued moot. The PSC therefore directed Farmers not to discontinue service to any of its existing customers until further order of the commission.

PSC Docket No. 84-135-C, Order No. 84-630:

This order, on August 10, 1984, approved the application of Farmers for a certificate of public convenience and necessity to provide RCC services within certain municipalities. It also approved Farmers' proposal to use the previously approved rates for these services.

The proceeding involved the testimony of some of Farmers'
executives as to the ability of the company to provide these services in these areas. Also testifying for Farmers were a variety of customers and potential customers assuring the commission of Farmers reliability and good service and of their desire for the new service in the municipalities. There were sixteen such witnesses including a doctor, a minister, the chief of a city police department, etc. A couple of these spoke of their unhappiness with Able's services.

Able called five witnesses who were users of Able's paging service. They spoke of their satisfaction with Able's service and reliability. Two of Able's officers then testified. One made assurances to the PSC that no complaint had ever been filed with the commission by any of its customers. The other told of a survey conducted by Able and of Able's concern over Farmers' proposed rates and the economic impact they would have on his company. There was one additional witness who testified further about the surveys conducted by Able and by Farmers.

The PSC found that the testimony of the various members of the public on Farmers' behalf was convincing evidence of a need and demand for the services proposed by Farmers. It was felt that since some members of the public were not satisfied with the service Able offered, this need and demand was not being met by existing RCC services in the area. It was also felt that since the paging services offered by Able and Farmers are different in that Able's system is manual and Farmers' is automatic and different customers were shown to have differing preferences, it would be possible for the two services to coexist in the same areas. Also, since Farmers admitted it had been providing certain RCC services in these areas for some time and Able had managed to coexist and compete even with higher rates, it was felt that Able could continue to do so. The PSC also required Farmers to maintain separate books and records on these services and to file quarterly reports of revenue, expenses, and return being earned on these services.

Court of Common Pleas, Case Number 84-CP-40-2966:

Able petitioned the court for judicial review of the PSC orders relating to Docket Number 83-436-C. The allegations Able made were that the findings and conclusions of the PSC were unsupported by or contrary to the evidence, that the PSC had failed to consider the economic impact on the financial stability of Able of the proposed rates, that the PSC had failed to require Farmers to set up an accounting system sufficient to separate all costs of its RCC services from those of its telephone services, and that the PSC erred in rescinding the cease and desist portion of the order. This rescission was characterized as an ex parte action because Farmers had not filed any petition with the PSC asking that the cease and desist order be revoked.

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The respondents' brief states that the evidence provided by Farmers was substantial and it supported the PSC's conclusions. It was further argued that although the consideration of economic harm is not required in a rate determination, the PSC did consider Able's testimony on this matter.

The court order on August 1, 1985, dismissed the petition. The opinion stated in part, "The decision of an administrative agency must be sustained if there is substantial evidence to support it." The court felt that from the record of seven witnesses and two days of testimony there was such evidence. Another finding was that although the PSC did appear to have considered economic impact in this case, such consideration was not required by statute or case law in a tariff determination proceeding. The court also found that the PSC did in its order require Farmers to maintain records to separate its paging operations from its telephone operations. The court found no requirement that the PSC make such an order but that the commission, if they desired, might do so. Finally, the court opinion stated that the power to issue a cease and desist order is discretionary. It was therefore seen to be within the PSC's discretion to rescind the order for any reason.

State Supreme Court:

Here the appellant, Able, questioned whether the lower court had erred in its findings in three areas analogous to the points brought in the lower court. These areas were the failure of the court to reverse and remand the PSC orders due to the failure of the PSC to make any factual findings, the failure to reverse and remand because the decisions and conclusions of the PSC were clearly erroneous, and, finally, the court's affirmation of the PSC's recision of its cease and desist order.

The respondents argued, naturally, that the PSC's order contained sufficient factual findings. They asserted that the lower court was correct in affirming the PSC's decisions and conclusions in view of the evidence of the record and in affirming the recision of its cease and desist order.

The court's decision, filed November 11, 1986, was to remand the case to the PSC. Their opinion stated in part, "The order contains no findings of fact at all. After reciting the conflicting testimony, the PSC merely concludes that Farmers' proposed rates are reasonable." The other issues brought by the appellant were not addressed in the opinion largely because the court felt that it could not review the order for error due to the insufficiency of the order.
Suggestions and Conclusions:

This case is primarily concerned with a determination of whether or not the tariff Farmers applied for is just and reasonable. Although the service would be a new one and therefore no historical cost data on its operation could be provided, the allocation method used seems clearly lacking. Indeed, the rates were initially set by Farmer's Telephone Cooperative, Inc. without a cost of service study until it was challenged by Able Communications, Inc.

The company did have experience with providing tone-only paging, but because Farmers kept its books according to the required Uniform System of Accounts no separate cost data related to that service was available. The officers of the company could not say whether they had experienced profits or losses on this service. Unless a detailed cost allocation study is performed, it would not be possible to determine whether Farmers' land line telephone customers were providing any cross-subsidies for the service. This case suggests that RTCs may set rates without an appropriate cost of services/cost allocation studies, which may create the potential for cross-subsidies, particularly where there is no regulatory oversight of the RTCs.
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Commission of South Carolina, Docker Number 83-436-C, In Re: Request of Farmers Telephone Cooperative, Inc. for approval of tariff filing to operate a paging service within its service area (Tariff No. 83-10), June 1, 1984.

Petition for Rehearing, Oral Argument and/or Reconsideration of Able Communications, Inc. before the Public Service Commission of South Carolina, Docker Number 83-436-C, In Re: Request of Farmers Telephone Cooperative, Inc. for approval of tariff filing to operate a paging service within its service area (Tariff No. 83-10), May 31, 1984.

CASE STUDY

HORACE B. AVANT, JR., MARION E. ANDERSON,
AND SATELLITE TV DEALERS OF GEORGIA, INC.
VERSUS
THE WASHINGTON ELECTRIC MEMBERSHIP CORPORATION
AND
BURTS V. REGISTER, AND SATELLITE TV DEALERS OF GEORGIA, INC.
VERSUS
THE LITTLE OCMULGEE ELECTRIC MEMBERSHIP
CORPORATION AND LITTLE OCMULGEE SERVICE CORPORATION
These two cases, Civil Action Numbers 85-SPCV-15 and 85-CV-005, brought in the superior courts of Washington and Wheeler counties, respectively, in the state of Georgia in July 1985, both involve the same issues and were later combined when brought before the state's supreme court. Central to the cases is the question of whether or not electric membership corporations (EMCs) in Georgia have the right to offer satellite television equipment for sale or lease to customers. The only differences between the two cases relate to the fact that the Little Ocmulgee EMC conducts certain activities through a wholly owned subsidiary, Little Ocmulgee Service Corporation. The two cases otherwise involve similar arguments and will be addressed simultaneously in all references below.

Background:

In 1984 the National Rural Electric Cooperative Association (NRECA) and the National Rural Utilities Cooperative Finance Corporation (CFC) funded an $80,000 telecommunications feasibility study to determine whether cooperatives nationwide should go into the satellite television business. Since the study results favored a movement into this area, the NRECA formed a new non-profit cooperative called the National Rural Utilities Telecommunications Corporation (NRTC) in 1985. The purpose of the NRTC is to oversee the entry of cooperatives into the satellite TV business. The NRTC determines equipment and installation specifications, provides for volume buying of equipment, tests equipment, and negotiates with manufacturers. Cooperatives wanting this service join the NRTC.

In Georgia, cooperative involvement in the satellite TV business began early. Cooperatives completed a six-month satellite television test project in December of 1984. Seven of Georgia's EMCs installed 100 dishes at customers' homes. The 100 dishes installed were all sold to the customers used in the test with financing from banks in the customer's area. Cooperatives began selling satellite dishes for television reception to other customers in early 1985.

These activities were opposed by some. The state legislature, which in 1981 prohibited EMCs from entering the cable television business, began considering the matter of EMC involvement in the satellite TV business in its 1984-85 session. House Bill 639, which passed by a vote of 109 to 36 in the state house of representatives on February 26, 1985, would have prohibited
Georgia's EMCs as well as Rural Telephone Cooperatives from engaging in the satellite TV business through sales, leasing or financing of satellite TV systems. HB 639 would also have prohibited EMCs from selling appliances. This bill never came to a vote in the state senate. It died in that senate's public utilities committee.

One factor which may have contributed to the fact that this legislation never reached the senate floor was an unofficial opinion issued by Georgia's attorney general Michael J. Bowers on March 4, 1985. This opinion stated that EMCs are not authorized to make sales of television antennae including satellite dishes. Mr. Bowers wrote that these activities violate the state's Electric Membership Corporation Act which limits rural cooperatives strictly to a set of functions closely tied to provision and conservation of electrical energy and service. If the senators accepted this unofficial opinion, then they would have found no reason to enact new legislation to prohibit EMCs from engaging in these activities.

Superior Court Cases:

Complaints alleging that the purchase, sale, and lease of satellite TV equipment by EMCs are ultra vires acts and asking the courts to restrain these EMCs from such activities were filed in both counties' superior courts in July 1985. An ultra vires act of a corporation is one in excess of its charter powers.

The first two plaintiffs in each case, according to the complaints, were members of the EMCs against which the cases were brought. In one of the cases, the EMC denied the first plaintiff was a member of the EMC and that name was later dropped from the case. The third plaintiff in each case, Satellite TV Dealers Association, was identified in the complaints as a Georgia non-profit corporation. The first two plaintiffs, who were in the business of selling satellite TV equipment, were members of this Association.

The plaintiffs claim that members of the Association are injured in their capacity as satellite TV dealers by the conduct of these EMCs and that the first two plaintiffs are also injured in their capacity as members of the cooperatives. They note that an EMC must act consistently with the powers set forth in the Official Code of Georgia Annotated (O.C.G.A.) § 46-3-200 which states that an EMC may serve any one or more of the following purposes:

1. To furnish electrical energy and service;
2. To assist its members in the efficient and economical use of energy;

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(3) To engage in research and to promote and develop energy conservation and sources and methods of conserving, producing, converting, and delivering energy; and

(4) To engage in any lawful act or activity necessary or convenient to effect the foregoing purposes.

The complaints also state that, pursuant to O.C.G.A. § 46-3-202, any member of an EMC may sue the corporation to enjoin the doing of any act or the transfer of personal property to or by the EMC which is invalid by reason of the fact that the EMC was without capacity or power to do such act or to make or receive such transfer.

The position of the plaintiffs expressed in count one of the complaints is that the purchase, sale, and lease by the EMCs of equipment used to establish satellite TV reception are acts not in accordance with the purposes set forth in O.C.G.A. § 46-3-200 and are therefore ultra vires acts subject to injunction pursuant to O.C.G.A. § 46-3-202. They assert that the statute should be strictly and narrowly construed. The plaintiffs propose in count two of the complaints that these actions are also unlawful and contrary to equity and public policy because they represent unauthorized, unfair and ultra vires use of financial power derived from public funds to enter the competitive business market for the sale and lease of satellite TV equipment and are therefore subject to injunction pursuant to O.C.G.A. § 9-5-1. Motions for preliminary and permanent injunction based on count one only were filed by plaintiffs.

The defendants freely admitted to having engaged in the systematic purchase, sale, and lease of equipment used to establish satellite TV reception including but not limited to sale and lease of dish antennae and receivers as claimed by the plaintiffs. The EMCs further stated that the equipment they purchased, sold, leased, and serviced has many other uses in addition to satellite TV reception. The EMCs also acknowledged having received low-interest government loans from the REA, but they denied having used government loan funds to finance the purchase, sale, or lease of satellite TV systems either directly or through use of personnel, equipment, and facilities paid or financed in whole or in part through such funds.

The position of the defendants is that EMCs as corporations created and existing pursuant to the Georgia Electric Membership Corporation Act, O.C.G.A. § 46-3-170 et seq. have the right to sell, lease, and service satellite television systems under state law. They claim such activities are within the purposes and powers granted to Georgia EMCs. Defendants note that Georgia EMCs are explicitly prohibited from operating cable television systems and suggest that, under the principle of inclusio unius est exclusio alterius (the inclusion of one thing is the exclusion of all
others), the sale of satellite TV systems by EMCs is implicitly authorized. They further claim that the existence of proposed legislation, HB 639 under consideration in the Georgia senate's 1985 session, to prohibit sale of satellite TV systems by EMCs shows that they are currently authorized to engage in these sales. Defendants also contend that plaintiffs' claims are barred under various state and federal statutes and that plaintiffs lack standing to assert such claims. They say the plaintiffs do not adequately represent the members of their cooperatives and that their satellite TV sales activities inure to the benefit of these members.

Defendants assert that, in considering O.C.G.A. § 46-3-200, an overall reading of the statute indicates that they are authorized to sell all types of electrical appliances, equipment, and supplies including satellite television equipment. They suggest that such a broad reading of the statute is sensible because of rapid changes in technology and that the Georgia legislature could not have anticipated new developments that might arise in the field of rural electrification. They point out that their power to assist members in the efficient and economical use of energy includes but is not limited to the installation of wiring, insulation, electrical machinery, supplies, apparatus, and equipment of any and all kinds or character according to O.C.G.A. § 46-3-201 (b) (8).

Additionally, although defendants deny the allegation of having used REA loans to finance satellite TV sales, they maintain that the use of federal monies by an EMC to compete is legal and does not constitute unfair competition. They say Georgia statutes do not qualify how borrowed money may be used except that the use must be consistent with the purposes of an EMC listed in O.C.G.A. § 46-3-200. They claim that, even assuming REA funds were used to subsidize such sales, the plaintiffs, as competitors of the EMCs, lack standing to bring an action to prevent competition in the sale or leasing of satellite television equipment. Defendants therefore moved to dismiss both counts of the plaintiffs' complaints.

Another group, Georgia Association of Broadcasters, Inc., along with several broadcasters that are licensees of Georgia television stations filed motions for intervention. The interveners' complaints are similar to count two of the original plaintiffs' complaints. They allege that EMC involvement in the satellite TV business represents unauthorized, unfair, and improper use of financial power derived from public funds to enter the competitive business market for the broadcast of television programs and events. They contend that people who purchase satellite TV equipment from the defendants are less likely to tune into interveners' programming which decreases interveners' viewing audience and advertising revenues.

Defendants opposed the motions to intervene. Their response
claims that the applicants for intervention have no interest in this action because they have no legal right to prevent the interception of their broadcast signals. They further suggest that the motion for intervention should be denied because an unfavorable disposition of the main action would have no effect on the applicants in any separate suit filed. Finally, they note that, since the objective of the applicants is identical to that of the plaintiffs, applicants' interest is adequately represented by the plaintiffs.

Superior Court Rulings:

Both courts granted the plaintiffs' motions for preliminary and permanent injunction pursuant to count one of the complaints and dismissed count two of the complaints. In addressing the motions for injunction and the motions for dismissal of count one of the complaints, the courts perceived the central issue to be that of whether the sale, purchase or lease of satellite TV reception equipment by an EMC is an ultra vires act in violation of Georgia law.

EMCs were found to be creatures of statute possessing only such powers as are authorized by the statute creating them. It was the decision of the courts that these powers are to be strictly construed. Precedent citings were the same in both rulings. The unofficial opinion of the attorney general was also cited in the rulings. The finding was that the Georgia Electric Membership Corporation Act granted no authority empowering defendants to sell, purchase, or lease satellite TV reception equipment. Such activities were therefore found to be ultra vires acts.

Plaintiff Satellite TV Dealers Association was not a participant in count one of the complaints nor the motions for preliminary and permanent injunction based upon count one because the doctrine of ultra vires can only be asserted against an EMC by a member of the EMC. Only one of the court rulings directly addressed the motion to intervene by Georgia Association of Broadcasters, Inc. and Others, but it is clear that for the above reasons these applicants for intervention could not participate in count one of the complaint either. One of the courts found that the plaintiffs, as competitors, did not have standing to sue on count two of the complaint and so dismissed this count. The other court simply dismissed count two of the complaint as moot.

State Supreme Court:

The EMCs filed appeals in both cases which were combined by the court and the arguments were heard together before the supreme court of Georgia in April 1986. The appellees in the case were only those original plaintiffs from the superior court cases who were members of the EMCs sued.
In addition to the briefs of appellants and appellees, amicus curiae briefs were filed by several parties. Briefs supporting the position of the appellees were filed by Satellite TV Dealers Association of Georgia, Inc., Georgia Association of Broadcasters, Inc., Georgia Cable Television Association, and the attorney general of the state of Georgia. Amicus curiae briefs supporting the appellants' position were filed by Georgia Electric Membership Corporation, and the National Rural Electric Cooperative Association and National Rural Utilities Cooperative Finance Corporation.

The ruling still turned on the question of whether the Georgia legislature's enumerations of powers and purposes of EMCs authorize them to sell satellite television dishes. The court's decision cited precedent for construing the economic aspects of the Georgia Electric Membership Corporation Act in a manner that would broaden competition. It was noted that statutes designate purposes and grant powers to each EMC to assist its members in the economical use of energy. It was found that EMCs are permitted to sell electrical appliances to members. Further, it was found that satellite dishes constitute electrical appliances.

The decision was that the trial court had ruled correctly to the extent that its injunction forbade EMCs from selling satellite television dishes to non-members. It was found, however, that the courts should have limited the injunction to that extent and allowed EMCs to sell the dishes only to EMC members. The judgment of the superior courts was, therefore, affirmed in part and reversed in part.

Conclusions:

Rural electric and telephone cooperatives in many areas of this country have, in recent years, begun offering satellite television equipment for sale or lease. Although the ruling in this case pertains only to Georgia's EMCs, it is of great importance to small, independent satellite television dealers all across the nation. Thus far, rural utility cooperatives, which have national organizations to assist them in purchasing and financing equipment on favorable terms, retain the right to compete in this important and rapidly growing market. It remains to be seen whether state legislatures in Georgia or elsewhere will act to forbid these rural cooperatives from participating in this market and, if so, whether such legislation will hold up in the courts.
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Brief in Response to Defendant Washington Electric Membership Corporation's Motion to Dismiss Plaintiffs' Complaint, Served September 13, 1985.

Brief of Defendant Washington Electric Membership Corporation in Opposition to Applicants' Motion to Intervene, Served October 14, 1985.

Complaint Sworn to July 1, 1985.


Defendant's Reply to Plaintiffs' Brief in Response to Defendants' Motion to Dismiss Plaintiffs' Complaint, Served October 15, 1985.

Defendant's Response to Plaintiffs' Motion for a Preliminary and Permanent Injunction, Served October 21, 1985.


Plaintiffs' First Request for Admissions, Served August 1, 1985.


Plaintiffs' Supplemental Brief and Reply.

Plaintiffs' Supplementary Summary Brief, Served November 11, 1985.

Ruling on Plaintiffs' Motion for Injunction and Defendant's Motion to Dismiss, December 19, 1985.

In the Superior Court of Wheeler County, State of Georgia, Civil Action File Number 85-CV-005, Burts V. Register, and Satellite TV Dealers Association of Georgia, Inc., Plaintiffs versus The Little Ocmulgee Electric Membership Corporation, Little Ocmulgee Service Corporation, Defendants:


Answer of Defendant Little Ocmulgee Service Corporation, Sworn to August 8, 1985, Served August 14, 1985.

Brief in Response to Defendant Little Ocmulgee Electric Membership Corporation's Motion to Dismiss Plaintiffs' Complaint, September 13, 1985.

Brief of Defendants Little Ocmulgee Electric Membership Corporation and Little Ocmulgee Service Corporation in Opposition to Applicants' Motion to Intervene, Served October 14, 1985.

Complaint Sworn to July 1, 1985.


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In the Supreme Court for the State of Georgia, Case Number 43143, The Washington Electric Membership Corporation, Appellant, versus Horace B. Avant, Jr., et al, Appellees, and Case Number 43215, The Little Ocmulgee Electric Membership Corporation and Little Ocmulgee Service Corporation, Appellants, versus Burts V. Register, Appellee:

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Consolidated Brief of Appellees Horace B. Avant, Jr., Marion E. Anderson and Burts V. Register, Served April 1, 1986.

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Motion for Leave to Participate in Case, Submitted by Paul Glist, Attorney for Georgia Cable Television Association, Served April 18, 1986.


CASE STUDY
THE GEORGIA PUBLIC SERVICE COMMISSION'S INVESTIGATORY DOCKET INTO
THE PROMOTIONAL PRACTICES OF ALL REGULATED ENERGY COMPANIES
(GEORGIA PUBLIC SERVICE COMMISSION, DOCKET No. 3618-U).
This proceeding was initiated by the Georgia Public Service Commission (the Commission) at its Administrative Session of September 24, 1986, as an investigation into the promotional practices of all regulated energy companies in Georgia. The Commission staff conducted a preliminary study on this subject and determined that hearings would be necessary. The general purpose of the investigation is to determine the nature and extent of the promotional practices being engaged in by the energy utilities; whether those practices should be regulated; and, if so, the best method of regulation.

The Issues:

The following emerged as issues to be addressed under the general topic of promotional practices:

1. What constitutes promotional practices and how should the term be defined;

2. To what extent does the Commission have the authority to regulate the promotional practices of the investor-owned utilities;

3. Does the Commission have the authority to regulate the promotional practices of the electric membership corporations;

4. In what manner should the Commission regulate promotional practices? On a rate case by rate case basis, by Administrative Procedure Act rule or in separate generic proceedings for each company or each industry;

5. Should certain promotional practices, such as cash payments or cash incentives, be prohibited? As to those promotional practices which are permitted, should the utility be permitted to recover the expense as a cost of service item for ratemaking purposes;

6. To what extent does a utility's extension policies constitute a promotional practice and are the utilities properly applying their tariffed extension rules; and

7. To what extent does rate design constitute a promotional practice and how should rate design fit into an overall energy policy.
The Parties' Positions

Georgia Power and Savannah Electric and Power Company (SEPCO) argue that in the marketplace the decision to engage in promotional practices is a management decision over which the Commission has no authority.

On the other hand, Atlanta Gas and United Cities Gas, along with the Consumers' Utility Counsel (CUC) and the Commission staff, urge that regulation of promotional practices is within the Commission's jurisdiction and that such regulation is necessary in order to allow fair competition and to give the ultimate consumer a free choice of energy supplier.

Similarly, The Georgia Propane Dealers Association urges the Commission to regulate the promotional practices of all energy companies in the State, including electric membership corporations. The propane dealers do not suggest what should be regulated or in what manner, besides that all financial inducements for the purchase or installation of appliances should be prohibited.

Overview of Utility Promotional Practices:

The evidence presented at the hearings in this case established that the utilities in Georgia are actively engaged in promoting the sale of their products. The main arena for competition is in the home heating market where the gas and electric utilities compete intensely for new space heating load.

One of the major points presented at the hearings was that a large majority of these promotional practices are targeted at builders and other persons who will not ultimately be responsible for the payment of the utility bills generated by these policies.

While the promotional practices of various Georgia utilities were presented at the hearings, only the policies of electric membership corporations (EMC's) will be discussed for the purpose of this report.

There was evidence presented at the hearings that promotional practices engaged in by EMC's ranged from substantial cash payments to long-term, no interest loans.

Carroll EMC is one of the more active EMC's regarding the use of promotional practices. For example, under the Carroll EMC program, a member could receive a rebate of $480 for installing an electric heat pump in addition to getting a free hot water heater.

There was also testimony at the hearings regarding Cobb EMC, which pays $250 for installation of a heat pump, but only if gas heat is not used with it.
Jackson EMC, another aggressive EMC in terms of promotional practices, carries the process one step further, offering a 5 percent loan in addition to a $400 payment in order to induce its customers to install heat pumps. Also, Jackson EMC combines these programs with instructions to its members on how to secure a loan/grant of up to $2,000 from the Georgia Energy Fund.

Thus, in a given situation a member of Jackson EMC could receive $400 for installing a heat pump, have the heat pump financed at a 5 percent interest rate, receive an additional $2,000 from the Georgia Energy Fund, yet be required to pay back only $1,000 to the Georgia Energy Fund. Although the Georgia Energy Fund might not reimburse the homeowner for purchase of a heat pump, the ability to combine that fund with other benefits being offered by the EMC as promotional practices provides a significant potential for abuse of Georgia Energy Fund grants and loans.

The significance of the testimony regarding the promotional policies engaged in by the aforementioned EMC's is that they are located in or near the Metropolitan Atlanta area and therefore have the potential to impact other regulated utilities in that area.

Argument in Support of the Regulation of Promotional Practices of EMC's:

The evidence presented during the course of the proceedings by advocates of regulation demonstrated that there is intense competition between the gas companies and the electric companies over potential load that can be served by either energy source. The impact of the promotional practices is that a developer may select to utilize a particular energy source in a development not because of a rational decision that a particular energy source is more efficient for the particular application, but because a cash payment or other incentive is being offered by a utility. Therefore, the effect of the promotional practices engaged in by all the utilities in Georgia is to deprive the ultimate consumer of the choice of energy supplier.

The Georgia Propane Gas Association argues that if the Commission determines that it has authority to regulate promotional practices, policies and procedures of investor-owned utilities under the Commission's inherent supervisory powers, it should also conclude that it has a similar power with respect to EMC's since EMC's have not been exempted from the Commission's general supervisory power.

Recommended Decision of the Hearing Officer:

According to Robert B. Remar, Hearing Officer, Georgia Public Service Commission, competition among competing energy suppliers is healthy when it increases efficiency, maximizes customer choice and restrains price. However, certain of the promotional practices
engaged in by the energy utilities in Georgia hinder rather than further these goals. In particular, the use of monetary inducements to choose a particular energy source constitutes unfair competition, reduces consumer choice, creates economic inefficiencies, and discourages the conservation of energy.

The provision of reliable energy at reasonable price is in the public interest. Fair competition in the energy market will help to increase the efficiency of utilities, restrain price, provide enhanced value to the consumer, and maximize customer choice. Accordingly, the Commission declares that the adoption and enforcement of new rules and regulations, governing the promotional activities of electric and gas utilities, is in the public interest. The rules seek to advance the welfare of all consumers by establishing standards for promotional programs; by specifying promotional practices which are prohibited as begin contrary to the public interest; by allowing the employment of promotional practices which are consistent with fair and vigorous competition among the utilities; and by setting forth the standards under which promotional practices will be considered as allowable expenses for public utility ratemaking purposes.

The Commission also has the authority to regulate EMC's in the same manner that it regulates investor-owned utilities in regard to promotional practices, provided that such regulation does not fix the cooperatives' rates, charges or services rules and regulations.

Conclusions:

As it was demonstrated in this case, competition by cooperative utilities for an increased share of the utility market encourages every effort to sell and install appliances at artificially low prices in order to encourage fuel switching. As stated by the Hearing Officer in the recommended order, the use of monetary inducements to choose a particular energy source constitutes unfair competition, reduces consumer choice, creates economic inefficiencies, and discourages the conservation of energy. While these kinds of promotional practices are utilized nationwide, very few states currently have any rules or regulations to deal with this type of unfair competition.
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CASE STUDY

NATIONAL LP-GAS ASSOCIATION (NLPGA)

AND

ALLIANCE FOR FAIR COMPETITION PETITIONED

THE

U.S. RURAL ELECTRIFICATION ADMINISTRATION

TO RESCIND REA BULLETIN 20-23.
NATIONAL LP-GAS ASSOCIATION (NLPGA) & ALLIANCE FOR FAIR COMPETITION
PETITIONED THE U.S. RURAL ELECTRIFICATION ADMINISTRATION TO
RESCIND REA BULLETIN 20-23.

The NLPGA and the Alliance for Fair Competition, hereinafter referred to as the Coalition, have petitioned the U.S. Rural Electrification Administration to rescind REA Bulletin 20-23, dated December 8, 1980, and any amendments thereto. This bulletin sets forth policies, procedures and guidelines for electric borrowers in the establishment of Energy Resources Conservation (ERC) loans and in obtaining extensions of certain scheduled principal repayments to REA to make funds available for such ERC loans. The REA presently allows the cooperatives to use the deferred principal repayments to offer 5 percent loans to customers to finance the sale and installation of water heaters, heat pumps, central heating or air conditioning systems and other energy conservation measures.

The petition was filed with the Rural Electrification Administration (REA) on May 28, 1987. Copies of the petition were provided to the Federal Trade Commission and the Office of Management and Budget.

Background of Organization:

The National LP-Gas Association (NLPGA) is the national trade association of the LP-gas industry with a membership of approximately 4,100 including 47 affiliated state and regional LP-gas associations representing all 50 states. Although the members of NLPGA include producers, transporters, wholesalers, and retailers of propane gas as well as the manufacturers and distributors of associated equipment and appliances, the largest single group within the membership are retail marketers of propane.

These marketers sell propane gas and associated appliances to homeowners, businesses, and industrial users who employ propane in over 18 million installations nationwide including over half of America's farms. These farm and other residential users use propane gas for heating, cooking and water heating. Thus, propane gas marketers are direct competitors with rural electric cooperatives in the furnishing of energy for heating, cooking and water heating.

The Alliance for Fair Competition is a national coalition of organizations and companies. Its members are independent businesses that compete with the diversified activities of gas and electric utilities, including rural electric cooperatives. The members of the Alliance include: Air Conditioning Contractors of America, American Supply Association, National Electrical Contractors Association, Petroleum Marketers Association of America, and Sheet Metal and Air Conditioning Contractors National Association. The companies represented by the Alliance members include suppliers of fuel oil; wholesalers of heating and cooling equipment; and
contractors providing installation, service and maintenance for heating, cooling and lighting equipment.

Major issues against RECs:

The Coalition petitions for the immediate rescission of REA Bulletin 20-23 for the following reasons:

(1) The ERC loan program established by REA Bulletin 20-23 is premised on an alleged "energy crisis". Such an "energy crisis" did not exist in 1980 at the time the program was established, nor does it exist in 1987. Thus, the alleged justification for REA loan repayment deferrals is specious at best.

(2) At a time of severe budgetary problems when every Government agency must observe strict controls on its finances in order to reduce the massive deficit which continues to grow each year, there can be no excuse for maintenance of any program which permits prolonged delays in repayment of legitimate debts to the U.S. Treasury on grounds which were questionable at the beginning and without substance in 1987.

(3) REA cooperatives enjoy a preferred position in the competitive marketplace by virtue of their tax exempt status, their access to substantially below-market interest rates, and, in many jurisdictions, their exemption from any form of utility regulation. This preferred position has given them the opportunity to abuse and misuse the ERC loans and Section 12 repayment deferrals allowed by REA Bulletin 20-23 in an unfair and anti-competitive manner.

Argument I - There is no energy crisis:

Part II.A. of REA Bulletin 20-23 provides:

"REA recommends that its electric borrowers assist their residential and other consumers to conserve and use energy wisely for their own benefit as well as that of the borrower and the Nation. Because of the energy crisis and consistent with the purposes of the Rural Electrification Act as amended, it is in the national interest for REA to permit the extension of certain scheduled principal payments to make funds available which can be used by borrowers in ERC Loan Programs."

The above statement appears in the December 8, 1980, edition of REA Bulletin 20-23, less than two months before newly-elected President Ronald Reagan issued Executive Order No. 12287, which
removed all remaining price and allocation controls from crude oil and certain petroleum products: the last remaining vestiges of an energy crisis which began in 1973 and which many contend ended some two or three years thereafter. With the exception of certain gasoline shortages prompted by the Iranian Crisis in early 1979, this nation has not known an "energy crisis" since the early to mid-1970's.

Moreover, the Coalition believes that this program has the effect and intent of encouraging people to switch from gas or oil heat to electric. Not only does this run counter to the energy policies of this nation, and Congressional and Department of Energy (DOE) policies against fuel switching, but it is a disservice to energy consumers nationwide since, in most instances, it is more economical to use gas or oil than electricity for home heating, cooking and water heating.

In further support of this position, the Coalition offers the following:

(1) According to the Federal Register of April 2, 1987, pages 10606-07, while the average consumer cost of electricity is $23.27 per million Btu, the average consumer cost of all other competing fuels ranges from a low of $5.62 to a high of $7.69 per million Btu. This belies any claim that electricity is cheaper or more economical than gas or oil heat.

(2) On May 4, 1987, the U.S. House of Representatives passed without dissent H.R. 1941, which repeals and amends certain sections of the Powerplant and Industrial Fuel Use Act of 1978 (FUA). As Rep. Phillip R. Sharp (D-IN), Chairman of the House Energy and Commerce Subcommittee on Energy and Power, stated during floor colloquy on the bill, the FUA is:

"an anachronism that barred large energy consumers from burning oil and gas because oil and gas were going to be scarce and high priced. But those predictions turned out wrong, and now we're going to repeal most of the act's end-user restrictions which were placed on the use of natural gas for electrical power generation. If these restrictions ever were needed, certainly they are not needed now."

Rep. John Bryant (D-TX) stated:

"The restrictions imposed by the
Fuel Use Act on industrial and utility users are no longer necessary. They were imposed during a time of shortage and may have made some sense in directing limited supplies of these fuels to residential users. In today's marketplace those restrictions not only contradict the forces of the marketplace, but all logic."

In similar fashion, REA Bulletin 20-23, although of questionable logic at the time of its promulgation, defies logic as to why it should remain in place. It certainly contradicts the forces of the marketplace and, quite apparently, the feelings of Congress: the Senate took up and passed H.R. 1941 without debate on May 7, 1987, and the President signed it into law on May 21, 1987.

(3) Attention is also drawn to the DOE Residential Conservation Service (RCS) Program and the Commercial and Apartment Conservation Service (CACS) Program as provided for in the National Energy Conservation Policy Act, as amended (Pub. L. 96-294). These programs were substantially altered by the Conservation Service Reform Act (Pub. L. 99-412) which repealed most of the CACS program. There was, however, substantial Congressional and agency concern about the anti-competitive impacts of these programs and the potential for abuse by utilities performing residential energy audits. Reflecting these concerns, the DOE regulations in Title 10 CFR prohibited fuel switching and unfair or discriminatory activities.

Of particular interest to the Coalition here are the prohibitions on fuel switching, an activity which is encouraged by REA Bulletin 20-23. In recently published interim regulations which appeared in the March 4, 1987, Federal Register, pages 6710-59, the list of approved Energy Conservation Measures in 10 CFR Sect. 456.105(f) includes Furnace Efficiency Modifications which are defined to include:

"Replacement Furnaces or Boilers. The term replacement furnaces or boilers means a furnace or boiler of the same fuel type and which replaces an existing furnace or boiler of the same fuel type and which reduces the amount of fuel consumed due to an increase in combustion efficiency, improved heat generation, or reduced heat losses."

Thus, DOE, taking its lead from Congress in the National Energy Conservation Policy Act, promotes energy conservation, but only so long as it does not include fuel switching. Surely, REA
policies should nor differ.

**Argument II - Unfair and anti-competitive practices:**

The Coalition claims that REA cooperatives have been using Bulletin 20-23 and the ERC loan program to compete unfairly with other energy fuels wholesalers, retailers and contractors in the sale and installation of equipment and appliances. The rural electric cooperatives enjoy two very substantial advantages over traditional competitors in their offering of energy services: electric cooperatives are exempt from federal income taxes under Section 501(c)(12) of the Internal Revenue Code, representing about 80 percent of all organizations in terms of assets and revenues exempt under that Code section; and they have access to loan money from the U.S. Government at interest rates which are substantially below market rates in 1987, 5 percent and, in some special cases, 2 percent. This combination of tax exempt status and access to below-market interest loans guarantees these entities a governmentally-sanctioned competitive advantage.

While it is recognized that these advantages were intended by Congress in 1936 when the Rural Electrification Act was passed, in 1987, when 99 percent of America's farms enjoy the advantages of electricity, the continued existence of these advantages needs to be examined. Moreover, the Coalition feels that Congress never intended to permit cooperatives to use these advantages in such a flagrantly anti-competitive and unfair manner. These advantages were merely intended to permit the economical and efficient extension of electric service into remote rural areas.

Members of the Coalition have received documents recording numerous examples of these unfair and anti-competitive practices from member companies across the nation. Attention is directed to the following specific examples:

* Eastern Illinois Power Cooperative, Paxton, Illinois. Dual heat incentives are $50 to $100 for conversions. Their literature states: "The cooperative will defer its quarterly payment of principal on REA loans and use this deferred principal as available loan funds to lend to any member." The cooperative offers loans of $500 to $3000 at 5 percent interest for 60 months.

* Boone Electric Cooperative, Columbia, Missouri. The cooperative offers a hot water heater free or at wholesale cost. Terms of the sale depend on whether the homeowner is converting from gas to electric or replacing an existing electric heater.

* Ozark Electric Cooperative, Mt. Vernon, Missouri. They are advertising their "ERC Loan Program": 5 percent
financing up to $1500 with 84 months to repay for the water heaters, heat pumps, insulation, and storm windows. Rebates are offered: $100 for first time installation of electric water heaters or gas replacement; $40 to replace old electric water heater; up to $300 for heat pumps.

Unfair, misleading and deceptive statements regarding the safety of gas or oil heating equipment, the current or projected pricing of gas or oil as compared to electricity, and the comparative efficiencies of gas or oil heating equipment versus electric equipment are found repeatedly in the literature distributed by these cooperatives. Electric rates of 2 to 3 cents per kilowatt hour are being advertised as a variation on the "bait and switch" tactics found in other businesses: normal rates range from 7 to 22 cents per KWH (the April 2, 1987, Federal Register states that the representative average unit cost of energy for electricity is 7.94 cents per KWH).

The Coalition feels that the indirect use of REA loan proceeds, through deferred repayment of federal loans, allows cooperatives to unfairly compete with existing wholesalers, retailers and contractors in the sale and installation of equipment and appliances. The use of loans made at a 5 percent interest rate by cooperatives provides them with a substantial advantage over competitors who borrow at rates which are several points over the prime rate. The competitive advantage to cooperatives is further escalated when a cooperative sells below comparable market prices.

Argument III - The need for tighter budget constraints

The Coalition believes that the Rural Electrification Administration must observe the tightest possible financial control at a time of high budget deficits. Statements by the REA Administrator have indicated that cooperative borrowers themselves are financially strong. The General Accounting Office, in a report they issued in January 1983, found that electric cooperatives generally are strong, healthy financial enterprises often as large and as financially sound as their private utility competition.

Yet, as of February 28, 1987, Bulletin 20-23 had permitted cumulative deferred REA loan repayments of $39,921,261. The Coalition feels that this $40 million in loan deferrals is a substantial sum of money that should be flowing into the U.S. Treasury on a regular basis.

Conclusions

Based on the NLPGA survey presented in the preceding section, in which 40 percent of the respondents "with complaints" indicated
that RECs in their service areas offered financing and 13 percent offered rebates, it can be stated that the Coalition's argument concerning ERC loans may have some merit.

The ERC loan program established by REA bulletin 20-23 may have encouraged the cooperatives to offer "free" electric water heaters, furnaces and other appliances to customers to promote "fuel switching." This action could result in a misallocation and waste of society resources. A cross-subsidy would be involved unless RECs recover the promotional costs through increased electric sales and electric customer base. Cooperatives, who enjoy a preferred position in the competitive marketplace by virtue of their special tax treatment and access to substantially below-market interest rates, could drive from the market even efficient and well-managed small businesses that did not have access to similar business advantages.

On June 16, 1987, the Coalition received a letter from Mr. Harold V. Hunter, the REA Administrator, who states that the REA is reviewing the merits of REA Bulletin 20-23 and will render its decision at a later date.
1. Letter to SVL Associates from Mr. Daniel N. Myers, Vice President, Government Relations & General Counsel, National LP-Gas Association, February 5, 1988.

2. Petition filed with The Honorable Harold V. Hunter, Administrator, Rural Electrification Administration. Petition submitted jointly by Mr. Daniel N. Myers, Vice President, Government Relations & General Counsel, National LP-Gas Association & Mr. Walter M. Reckinger III, Chairman, Alliance for Fair Competition, May 28, 1987.
CASE STUDY

CARROLL ELECTRIC MEMBERSHIP CORPORATION (EMC)
Draketown Gas, Inc. of Temple, Georgia, filed a complaint with the Governor's Office of Consumer Affairs charging Carroll EMC with violation of the Fair Business Practices Act. The core issue here is the matter of deceptive advertising.

Description of Case:

Complainants

Draketown Gas charged that in letters Carroll EMC sent to those constructing new homes or businesses, the cooperative quoted inaccurate figures on the costs of heating a home with an electric heat pump as compared with propane or natural gas heating. The annual cost figures were attributed to the Georgia Office of Energy Resources. These figures were shown to be inaccurate through reference to statistics published by the Department of Energy. The Georgia Office of Energy Resources has stopped issuing the fact sheet from which the inaccurate figures were quoted.

Utility

Carroll EMC has stopped sending out the letters with the incorrect figures. In their statement to the Commission they noted that James M. Autry, who sent the letters, is no longer employed by the company. EMC manager Gary Bulloch apologized to the Commission for "mislabeling" contained in the letters.

Decision:

The Consumer Affairs Commission met in closed session with Carroll EMC in March, 1988. The Commission ruled that the problem here was not one of mislabeling but of deceptive advertising. The cooperative has been asked to supply the Commission with a list of customers that received the letters containing the false cost data. The Commission will supervise the gathering of this information and independently verify it.

When all customers who purchased heat pumps after receiving the letters have been identified, it is the intention of the Commission to force Carroll EMC to make restitution to these customers. The restitution is expected to be equal to the difference between expected annual costs of using the heat pumps and the costs quoted in the letters times ten since the pumps are expected to last for ten years. There will also be a fine levied against the cooperative and the final results will be made public.
Conclusions:

This case represents a clear victory for the small business competitors of the rural electric cooperatives in what was their most often cited area of complaint in the survey of NLPGA members, that of deceptive advertising.
RECOMMENDATIONS

Regulators will have to deal with the problems of REC/RTC diversification activities to an increasing extent in the days ahead. A major concern in this area, however, is the impact that increasing the responsibilities of regulators will have on the costs of regulation. It is clear, though, that some changes must be made.

The preceding analysis of the competition between small business and cooperatives provides the basis for the following recommendations:

1. Under the current federal budget constraint and the potential unfair competitive advantage of cooperatives against non-subsidized, tax paying small businesses, Congress may consider reforming the Rural Electrification Administration's loan program and evaluate alternative tax treatments for rural electric and telephone cooperatives as recommended by the United States General Accounting Office.

2. The state public utility commissions should be granted the authority to regulate all rural electric/telephone cooperatives operating within their jurisdiction in the same fashion as they regulate investor-owned utilities. The state public utility commissions would create an effective forum to raise cross-subsidization and unfair competition issues.

3. The Rural Electrification Administration and the state public utility commissions should require all cooperative borrowers with non-utility businesses to perform a detail annual cost of service/cost allocation study to avoid cross-subsidization between utility and non-utility operations.

4. The Federal Trade Commission, the Rural Electrification Administration and state regulators should take a closer look at the diversification of cooperatives into non-utility businesses so that a national policy toward preventing cross-subsidization and unfair methods of competition can be developed.

Until changes are made in the regulation of cooperatives, it would appear that the best strategy for small businesses is to form associations which can use financial resources and assets provided by a large membership to bring those cases of unfair competition to the level of national attention which offer the possibility of setting new regulatory precedents.
V. RECOMMENDATIONS