

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF OWEN COUNTY)
RURAL ELECTRIC COOPERATIVE)
CORPORATION TO CONVERT FIXED LOANS) CASE NO. 10045
TO VARIABLE INTEREST RATE)

O R D E R

On October 5, 1987, Owen County Rural Electric Cooperative Corporation ("Owen Co. RECC") filed a request that the Commission grant approval of the conversion of National Rural Utilities Cooperative Finance Corporation ("CFC") Loan No. 03-20-037-9011 ("9011"), Loan No. 03-20-037-9014 ("9014"), Loan No. 03-20-037-9016 ("9016"), Loan No. 03-20-037-9021 ("9021"), and Loan No. 03-20-037-9024 ("9024"), from a fixed to a variable interest rate. The terms of these 35-year loans originally provided for a fixed interest rate for the first 7 years, after which, the rate would be renegotiated. The fixed rate for these loans was 13 percent, 11 percent, 11.5 percent, 11.5 percent, and 11.75 percent, respectively. However, since the execution of these loans, interest rates have been substantially reduced and CFC has allowed borrowers to convert to a reduced variable interest rate. The variable rate applied to these loans was 7.25 percent at the time of conversion and is currently 8.25 percent. On October 23, 1986, and on November 20, 1986, Owen Co. RECC's Board of Directors voted to convert to the variable rate.

Exhibits filed with the Application reflect interest savings of \$144,026 realized for the period December 1, 1986, through August 31, 1987; projected interest savings of \$324,644 from August 31, 1987, until the applicable repricing date; and conversion fees of \$208,862. Owen Co. RECC projected a net savings of \$259,808. Listed below is an itemization of the above information for each loan as shown by Owen Co. RECC in Exhibit E:¹

<u>Loan No.</u>	<u>Savings 12/1/86 - 8/30/87</u>	<u>Savings Until Repricing Date</u>	<u>Conversion Fee</u>	<u>Projected Net Savings</u>
9011	\$ 19,514	\$ 35,653	\$ <38,919>	\$ 16,248
9014	10,522	35,521	<27,054>	18,989
9016	30,115	123,663	<90,608>	63,170
9021	51,793	31,164	<52,281>	30,676
9024	<u>32,082</u>	<u>98,643</u>	<u>-0-</u>	<u>130,725</u>
	\$144,026	\$324,644	\$<208,862>	\$259,808

All amounts above were based on comparative cash flow.

CFC loan policies provide that, on refinancing of existing loans, if certain conditions are met allowing a CFC borrower to use 12.25 percent as the buydown rate, no conversion fee will be charged if the actual fixed interest rate of the loan is 12.25 percent or below. Once the variable rate option has been selected a borrower may convert back to the fixed rate program at any time without a conversion fee and the rate will be fixed for a 7-year period.

The cash flow analyses presented in Exhibits A through E filed in support of the Application are not adequate to support

¹ Application, Exhibit E, filed October 5, 1987.

Owen Co. RECC's decision to convert to the variable rate. The presence of the conversion fee, the option to pay that fee in a discounted lump sum or as a sum amortized through the repricing date, and the change in principal payments reflected in Owen Co. RECC's response to the Commission's Information Request² are factors that cannot be adequately considered by a simple comparison of cash flows. Where a conversion fee and/or other changes in cash flow are involved, an informed decision-making process must incorporate a present value (or discounted cash flow) analysis that reflects the time value of money. In this case, as Owen Co. RECC responded in Item No. 1 of the Commission's Information Request, Owen Co. RECC did not perform a present value analysis.

The amount and timing of payments can have a significant impact on the actual savings when discounted back in a present value analysis. The presence of a conversion fee makes the decision to convert less obvious than a conventional comparison of cash flow would indicate for loans 9011, 9014, 9016, and 9021. Therefore, a present value analysis that recognizes the differences in the amount of principal payments, the timing and impact of the payment of the conversion fee, and that reflects expectations regarding future interest rates must be performed.

In this case, the Commission staff performed such an analysis which did substantiate that a positive savings will result for each conversion. The savings are not as large under the present

² Response to Commission's Information Request dated October 12, 1987.

value analysis as presented by Owen Co. RECC and show that under certain conditions negative cash flows may occur. However, under the conditions presented in this case, Owen Co. RECC's decision to convert the five loans is justified and the request should be granted.

However, decisions to refinance based solely on the comparative change in cash flow, as presented by Owen Co. RECC in this case, could result in decisions to convert when there is an apparent cash flow savings but an effective negative present value. Additionally, decisions could be made to refrain from conversion when there is a cash flow loss but a positive present value savings. Refinancing options must be analyzed on a present value (or discounted cash flow) basis in order to be able to make an informed decision.

Owen Co. RECC should, in future proceedings involving refinancing, provide an analysis in a manner that clearly reflects the associated costs and/or savings.

SUMMARY

The Commission, upon consideration of the evidence in support of this request, is of the opinion and finds that:

1. On October 23, 1986, and on November 20, 1986, the Board of Directors of Owen Co. RECC voted to convert CFC Loan Nos. 9011, 9014, 9016, 9021, and 9024 from the fixed to variable interest rate program.

2. These loans had previously been authorized by the Commission in Case No. 6287,³ Case No. 6657,⁴ Case No. 7029,⁵ Case No. 8196,⁶ and Case No. 8772.⁷

3. CFC has been charging the reduced variable interest rates pending the preparation of new loan documents and the approval by the Commission.

4. The conversion of the subject loans should result in interest savings on a present value basis and should be approved.

IT IS THEREFORE ORDERED that:

1. Owen Co. RECC's conversion of CFC Loan Nos. 9011, 9014, 9016, 9021, and 9024 from the fixed to variable rate program be and hereby is approved.

³ The Application of Owen County Rural Electric Cooperative Corporation for an Order Authorizing Said Corporation to Borrow \$1,194,000 from the United States of America, and \$510,000 from the National Rural Utilities Cooperative Finance Corporation, for the Purpose of Constructing Extensions to its Present Lines, Final Order entered July 10, 1975.

⁴ Ibid., Final Order entered November 29, 1976.

⁵ The Application of Owen County Rural Electric Cooperative Corporation for an Order Authorizing Said Corporation to Borrow \$2,528,000 from the United States of America, and \$1,083,000 from the National Rural Utilities Cooperative Finance Corporation, for the Purpose of Constructing Extensions to its Present Lines, Final Order entered March 28, 1978.

⁶ The Application of Owen County Rural Electric Cooperative Corporation for an Order Authorizing Said Corporation to Borrow \$4,010,000 from the United States of America, and \$1,809,000 from the National Rural Utilities Cooperative Finance Corporation, for the Purpose of Constructing Extensions to its Present Lines, Final Order entered May 19, 1981.

⁷ The Application of Owen County Rural Electric Cooperative Corporation for an Order Issuing a Certificate of Public Convenience and Necessity, Final Order entered May 31, 1983.

2. Owen Co. RECC shall notify the Commission of the closing date of the conversions.

3. Owen Co. RECC shall file with the Commission, within 45 days of the loan conversions, all documents pertaining to the finalization of said conversions.

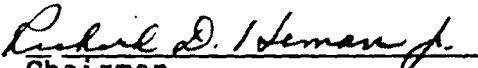
4. Owen Co. RECC shall file, along with its monthly financial report to the Commission, the current interest rate on its variable rate loans outstanding.

5. All provisions of the Commission's Orders in Case Nos. 6287, 6657, 7029, 8196, and 8772 not specifically pertaining to the CFC financing shall remain in full force and effect.

6. Owen Co. RECC shall analyze all future refinancing options in a manner that clearly reflects the costs and/or savings associated with such options.

Done at Frankfort, Kentucky, this 12th day of November, 1987.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director