

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF OWEN ELECTRIC)	
COOPERATIVE, INC. TO REFINANCE)	CASE NO.
AND CONVERT LOANS FROM FIXED)	92-377
TO VARIABLE RATE)	

O R D E R

On September 2, 1992, Owen Electric Cooperative, Inc. ("Owen") filed a request that the Commission amend its prior Orders entered in Case No. 7562¹ and Case No. 9578,² to authorize the conversion from a fixed to a variable interest rate for National Rural Utilities Cooperative Finance Corporation ("CFC") Loan Nos. 9019 and 9025. The term of these 35-year loans originally provided for a fixed interest rate for the first 7 years, after which, the rate would be renegotiated. 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 current fixed interest rate for this loan is 9.00 percent and 8.75

¹ Case No. 7562, The Application of Owen County Rural Electric Cooperative Corporation for an Order Authorizing Said Corporation to Borrow from \$3,737,000 from the United States of America and \$1,686,000 from the National Rural Utilities Cooperative Finance Corporation for the Purpose of Constructing Extensions to its Present Lines, and Other Purposes, Order dated September 31, 1979.

² Case No. 9578, The Application of Owen County Rural Electric Cooperative Corporation for an Order Issuing a Certificate of Public Convenience and Necessity and for the Authority to Borrow a Sum of \$2,107,368 from the National Rural Utilities Cooperative Finance Corporation and to Execute its Notes and Mortgages to Secure Such Loan, Order dated July 10, 1986.

percent, respectively. The variable rate applicable for this loan is 5.375 percent. On August 27, 1992, Owen's Board of Directors voted to convert to the variable rate.

When converting from the fixed rate program to the variable rate program, CFC requires the payment of a conversion fee. The conversion fee for each loan is based on the difference in the interest rate on the note and CFC's long-term interest rate at the time the borrower elects to convert to the variable rate. The difference is applied to the outstanding loan balance at the start of the borrower's next first full quarterly billing cycle for the time remaining until a repricing option would have been allowed. A one-time, up-front fee of 25 basis points on the outstanding balance at the time of conversion is added to the conversion fee. The conversion fee could be paid either in quarterly payments or as a discounted up-front payment. The total conversion fee would be \$59,013 if paid quarterly and \$56,407 if paid up-front.

Owen provided an Internal Rate of Return ("IRR") analysis for the loan it proposed to convert. Under the IRR approach, the goal of the borrower would be to utilize the interest rate program which produces the lowest IRR. For each loan, Owen determined an IRR value for the following three different scenarios:

1. The current variable rate remained constant for the remainder of the pricing cycle ("Scenario I").

2. The current variable rate would begin increasing by .25 percent each quarter, beginning with the third quarter after conversion, for the remainder of the pricing cycle ("Scenario II").

3. The third scenario involved determining the variable interest rates which, when applied beginning with the third quarter after conversion, would result in an IRR value approximately equal to the IRR value resulting from the current fixed interest rate. Owen considered this the break-even scenario.

Each scenario was run twice showing the impact on the IRR value of each payment option chosen for the conversion fee.

The analysis indicated that, under either Scenario I or II, the resulting IRRs for the variable interest rate were lower than the IRR for the fixed interest rate. The scenario results also indicate it is beneficial to Owen to pay the conversion fees up-front rather than quarterly. Scenario I resulted in a net cumulative savings of \$47,317 when the conversion fees were paid up-front and \$44,711 when the conversion fees were paid quarterly. Scenario II resulted in a net cumulative savings of \$25,433 when the conversion fees were paid up-front and \$22,827 when the conversion fees were paid quarterly. Under the assumptions incorporated in Scenario II, the increasing variable interest rate on individual loans resulted in significantly lower savings when the conversion fee was paid quarterly.

In its request, Owen indicated that it would pay the conversion fees up-front. Owen stated that it viewed the assumptions in Scenario II to be a "worst case" scenario. While

stating that it did not see variable interest rates increasing or decreasing dramatically in the next few months, Owen would continue to monitor interest rates and whenever indicators showed it to be advantageous, it would lock into a fixed rate. Based upon Owen's analyses and the conditions presented in this case, the conversions of the loan should result in interest savings on an IRR basis and the loan should be converted as requested.

IT IS THEREFORE ORDERED that:

1. The Commission's Orders entered in Case No. 7562 and Case No. 9578 be and they are hereby modified to authorize the conversion from a fixed to a variable rate program for CFC Loan Nos. 9019 and 9025.

2. Owen shall notify the Commission of the closing date of the conversions and shall file, within 30 days of the conversion, all documents pertaining thereto.

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

4. All other provisions of the Commission's Orders entered in Case No. 7562 and Case No. 9578 shall remain in full force and effect.

Done at Frankfort, Kentucky, this 9th day of October, 1992.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman

ATTEST:


Executive Director

