COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LICKING VALLEY RURAL ELECTRIC COOPERATIVE CORPORATION TO REFINANCE AND CONVERT LOANS TO A MID TERM RATE AND VARIABLE RATE	)	CASE NO. 92-522

O R D E R

On November 23, 1992, Licking Valley Rural Electric Cooperative Corporation ("Licking Valley") filed a request that the Commission amend its prior Orders entered in Case No. 6459,[1] Case No. 6797,[2] Case No. 7876,[3] Case No. 8833,[4] and Case No. 9551[5] to authorize the conversion from the standard fixed interest rate for National Rural Utilities Cooperative Finance Corporation ("CFC") Loan Nos. 9004, 9005, 9010, 9014, and 9015. The current standard

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1 Case No. 6459, The Application of the Licking Valley RECC for the Authorization to Borrow Five Hundred, Thirty-Eight Thousand ($538,000.00) Dollars from the United States of America, and Two Hundred, Thirty Thousand ($230,000.00) Dollars from National Rural Utilities Cooperative Finance Corporation, and to Execute Notes for Said Sums, Order dated February 17, 1976.

2 Case No. 6797, The Application of the Licking Valley RECC for the Authorization to Borrow Five Hundred, Thirty-six Thousand ($536,000.00) Dollars from the United States of America, and Two Hundred, Thirty Thousand ($230,000.00) Dollars from National Rural Utilities Cooperative Finance Corporation, and to Execute Notes for Said Sums, Order dated June 1, 1977.

3 Case No. 7876, The Application of the Licking Valley RECC for the Authorization to Borrow One Million, Seven Hundred, Twenty-Two Thousand ($1,722,000) Dollars from the United States of America, and Seven Hundred, Seventy-Seven Thousand ($777,000) Dollars from the National Rural Utilities Cooperative Finance Corporation, and to Execute Notes for Said Sums, Order dated August 1, 1980.

4 Case No. 8833, The Application of Licking Valley RECC for the Authorization to Borrow Four Hundred, Forty-Six Thousand ($446,000) Dollars from National Rural Utilities Cooperative Finance Corporation, and to Execute a Note for Said Sum, and for a Certificate of Public Convenience and Necessity to Make Certain Extension and Improvements to Its System, Order dated June 17, 1983.

5 Case No. 9551, The Application of the Licking Valley RECC for the Authorization to Borrow Four Hundred, Eighty Thousand, Four Hundred, Twelve ($480,412) Dollars from National Rural Utilities Cooperative Finance Corporation, and to Execute a Note for Said Sum; and for a Certificate of Public Convenience and Necessity to Make Certain Extensions and Improvements to Its System, Order dated May 27, 1986.

fixed interest rate for these loans was 8.75 percent, 8.50 percent, 8.75 percent, 10.50 percent, and 8.75 percent, respectively. Licking Valley proposed to convert Loan No. 9005 to a variable interest rate, currently stated at 5.00 percent; Loan Nos. 9010 and 9015 would be converted to a 5.625 percent, 2-year mid-term fixed interest rate; Loan No. 9004 would be converted to a 6.25 percent, 3-year mid-term fixed interest rate; and Loan No. 9014 would be converted to a 6.75 percent, 4-year mid-term fixed interest rate. The terms of these 35-year CFC 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. CFC has allowed borrowers to convert to either a variable interest rate or a mid-term fixed interest rate. Mid-term fixed interest rate loans are offered for annual periods shorter than the 7 year period in effect under the standard fixed interest rate program. Interest rates for the mid-term fixed interest rate program are set monthly. CFC began offering the mid-term fixed interest rate program in October 1992. On November 12, 1992, Licking Valley's Board of Directors voted to convert Loan No. 9005 to the variable rate and the remaining four loans to the mid-term fixed rate.

When converting from the fixed rate program to the variable or mid-term fixed interest rate programs, 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 standard, 7-year fixed interest rate at the time the borrower elects to convert to the variable or mid-term 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. Although CFC at one time allowed borrowers the option of paying the conversion fee in quarterly payments or as a discounted lump-sum payment, Licking Valley provided information documenting that effective October 1992, CFC would only allow the conversion fee to be paid in quarterly payments over the remaining portion of the pricing cycle. The total conversion fee for the five loans would be $75,626.

Licking Valley provided a series of Internal Rate of Return ("IRR") analyses for each 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, Licking Valley 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 second quarter after the conversion, for the remainder of the pricing cycle ("Scenario II").

3. The third scenario, which Licking Valley identified as modeling a fixed interest rate which would be near the break-even point, actually modeled the cash flow impact for each loan using

the interest rate program proposed by Licking Valley. For Loan No. 9005, Licking Valley modeled the interest rate as variable for four quarters and then fixed the rate; for the other four loans the appropriate mid-term fixed interest rate was used.

The analyses indicated that, under each scenario, the resulting IRRs for the variable or mid-term fixed interest rate were lower than the IRR for the standard fixed interest rate. Each scenario also indicated there would be net cumulative savings from the conversion. Scenario I indicated net cumulative savings of $62,916; Scenario II indicated net cumulative savings of $7,954; and Scenario III indicated net cumulative savings of $18,193.

In its application, Licking Valley stated that it did not expect interest rates to decline any further. Because of its concern over the volatility of short term interest rates, Licking Valley "[w]ants to diversify and mix their risks through a loan interest portfolio that takes advantage of existing opportunities while resulting in known savings through assured rates."[6] Thus, Licking Valley proposed to convert to both the variable and mid-term fixed interest rate programs. Licking Valley indicated that it would continue to monitor interest rates and leading economic indicators to determine at what point it would be feasible to convert to the standard fixed interest rate. Based upon Licking Valley's analyses and the conditions presented in this case, the

6 Application Exhibit D.

conversions of the five loans should result in interest savings on an IRR basis and the loans should be converted as requested.

As indicated in its application, Licking Valley informed the Commission on November 23, 1992 that it desired to convert these loans at the beginning of its next billing cycle, December 1, 1992. The Commission advises Licking Valley that in the future requests to convert loans should be made in advance of conversion, with sufficient time provided to allow for adequate review.

IT IS THEREFORE ORDERED that:

1. The Commission's Orders entered in Case Nos. 6459, 6797, 7876, 8833, and 9551 be and they hereby are modified to authorize the conversion from a standard fixed to a variable rate program for CFC Loan No. 9005 and from a standard fixed to a mid-term fixed interest rate program for CFC Loan Nos. 9004, 9010, 9014, and 9015.

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

3. Licking Valley 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 Nos. 6459, 6797, 7876, 8833, and 9551 shall remain in full force and effect.

Done at Frankfort, Kentucky, this 17th day of December, 1992.

PUBLIC SERVICE COMMISSION

Chairman

Thomas M. Dorman

Vice Chairman

Robert M. Davis

Commissioner

ATTEST:

Don Mills

Executive Director