COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE NOLIN RURAL ELECTRIC COOPERATIVE CORPORATION FOR AN ORDER PURSUANT TO KRS 278.300 AND 807 KAR 5:001, SECTION 11 AND RELATED SECTIONS AUTHORIZING THE COOPERATIVE TO OBTAIN A LOAN IN THE AMOUNT OF $4,300,000.00 FROM THE NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION	)	CASE NO. 99-259

O R D E R

On July 15, 1999, Nolin Rural Electric Cooperative Corporation (Nolin) filed an application seeking authority to borrow $4,300,000 from the National Rural Utilities Cooperative Finance Corporation (CFC). Nolin intends to use the proceeds of this loan to finance the payment of capital credits to its members pursuant to the Settlement Agreement approved and adopted by the Commission s August 7, 1995 Order in Case No. 94-402.[1] The amounts of capital credits to be retired are associated with cooperative earnings from calendar years 1995, 1996, 1997, and 1998.

The proposed CFC loan will be a 7-year loan with a 15-year amortization. When the loan matures at the end of the 7 years, it can be reamortized for another 8 years. This approach would reduce the cash flow requirements for Nolin, while keeping it within CFC s policy for unsecured loans. CFC indicated to Nolin that structuring the loan in this manner would also eliminate the need for it to pay Loan

[1] Case No. 94-402, Application of Nolin Rural Electric Cooperative Corporation Concerning Existing Rates.

Capital Term Certificates, which are often required in conjunction with CFC financing.[2] Nolin has indicated that it has chosen CFC s variable interest rate program for this loan.

In Case No. 97-502,[3] Nolin sought permission from the Commission to calculate its required 1996 capital credit retirements by offsetting calendar year 1995 earnings with calendar year 1994 losses. Nolin also sought permission to defer any capital credit retirements to be paid in calendar year 1997 until its Board of Directors and management determined that it was fiscally responsible to pay those capital credits. During the course of that proceeding, Nolin withdrew its request relating to the calculation of the required capital credit retirement to be paid in 1997. However, since a change had been sought in the calculation methodology, Nolin had not made the required retirements of capital credits to members based on earnings for calendar years 1995, 1996, 1997, and 1998.

In its October 20, 1998 Order in Case No. 97-502, the Commission denied Nolin s request to defer the retirement of capital credits under the terms of the Settlement Agreement. The Commission also ordered Nolin to prepare and file a plan for meeting its obligations to retire capital credits for calendar years 1995 through 1997. On December 18, 1998, Nolin filed its plan, which called for it to borrow funds from CFC to make capital credit retirements based on earnings for calendar years 1995, 1996, 1997, and the anticipated retirement based on 1998 earnings.

[2] Response to the Commission s July 29, 1999 Order, Item 1, Exhibit 1.

[3] Case No. 97-502, The Application of Nolin Rural Electric Cooperative Corporation for a Deviation from the PSC Staff s Position that Nolin Cannot Offset Losses Against Margins in Determining a Payout of Capital Credits and the Deviation from the Settlement Agreement of October, 1990 in Case No. 90-064.

Nolin s proposal to use long-term financing to pay its capital credit retirements is unique since such financing is typically limited to capital asset acquisition. However, Nolin s financial situation is also unique. Because of historic business decisions made by its Board of Directors and management, by the time of Nolin s 1990 general rate case, it had achieved an equity to total capitalization ratio (equity ratio) of 61.60 percent. The capital structure of electric cooperatives normally includes only 30 to 40 percent equity. In fact, Nolin s strong financial position had enabled it to fund capital construction work plans totally with internally generated funds and no long-term debt. Electric cooperatives, as not-for-profit entities, normally finance most if not all of their capital construction work plans with long-term debt.

As part of the settlement agreement in its 1990 general rate case, Nolin agreed that it needed to reduce its equity ratio to a more normal level and this was to be done by the systematic retirement of capital credits and the use of long-term financing for capital construction. Since 1990, Nolin s equity ratio has gradually decreased, and was below 50 percent by January 1998, as a result of both debt financing of capital construction and capital credit retirements.

Due to extended delays in receiving long-term debt financing from the Rural Utilities Service (RUS), Nolin and other electric cooperatives have had to rely on short-term debt until long-term debt is available. This reliance on short-term debt resulted in Nolin not being able to achieve a Current Ratio of 1.0,[4] which is required by its RUS mortgage before capital credits may be paid. Consequently, Nolin was unable to make

[4] The Current Ratio is the ratio of current assets to current liabilities. Nolin must have a 1.0 Current Ratio after the effects of a proposed capital credit retirement have been reflected in its financial statements in order to make the retirement.

the required capital credit retirements between 1996 and 1998. The prohibition on capital credit retirements, plus the position Nolin took when it originally filed Case No. 97-502, resulted in the outstanding capital credit retirement obligation exceeding the level of funds it had available, regardless of whether the Current Ratio requirement had been met or not. In the plan filed in response to the October 20, 1998 Order in Case No. 97-502, Nolin stated that it was obligated to pay $4,088,096 in capital credits for years 1995 through 1997, and estimated an obligation of an additional $1,200,000 for 1998.[5]

Based on the evidence of record and being sufficiently advised, the Commission finds that Nolin s capital structure is atypical due to its high equity ratio. Consequently, the traditional method of funding capital credit retirements with internally generated funds is unavailable. While Nolin s proposed solution is unusual, it is reasonable under the circumstances. The use of long-term debt to fund the outstanding obligation in effect continues the effort to bring Nolin s equity levels more into line with the norm for electric cooperatives. After the proposed borrowing and the capital credit retirement, Nolin s equity ratio will be approximately 35.6 percent.[6] The replacement of equity with long-term debt is reasonable because under normal circumstances Nolin would have issued long-term debt during the construction of new capital assets. In this instance, the availability of internally generated funds reduced the need for long-term debt. The

[5] Case No. 97-502, Response to Order of Commission of October 20, 1998, filed December 18, 1998., at 2.

[6] Based on Exhibit 4 of Nolin s application, its March 1999 financial statements, the total estimated capital credit retirement of $5,288,096, and the new financing of $4,300,000.

issuance of debt at this time to refund capital credits to members can be considered as correcting the excessive accumulation of equity in prior years. Nolin has worked with CFC to develop a solution to a difficult situation. This solution also allows Nolin to be in compliance with the terms of its Settlement Agreement, which continued the systematic retirement of capital credits.

While the correction of the excessive equity ratio and the payment of capital credits under the Settlement Agreement are major steps in accomplishing the goals of equity management planning, Nolin should take steps to avoid reversing the effects of this positive action. The terms of the Settlement Agreement were established in consideration of the earnings as they related to Nolin s capital structure at that time. Now that the excessive equity situation has been corrected, Nolin should reevaluate the terms of the Settlement Agreement to determine their impact on earnings, cash flow, and capital ratios. If the provisions for the rotation of earnings in excess of a 1.5 Times Interest Earned Ratio create negative impacts on cash flow and the equity ratio, Nolin should seek to modify the plan to arrive at terms that will manage equity given the current financial condition. If these corrective actions are not taken, Nolin may be faced with insufficient funds, or an inadequate Current Ratio to retire capital credits in the future and may run the risk of accumulating additional capital credit retirement obligations which cannot be met with general funds. Nolin should not consider long-term financing of capital credit retirements on a routine basis and should not attempt to manage equity through this means in the future. The Commission will make its Staff available if Nolin desires assistance in evaluating the need to modify its Settlement Agreement.

In summary, the Commission finds that:

1. The loan from CFC in the amount of $4,300,000 is for lawful objects within the corporate purposes of Nolin, is necessary and appropriate for and consistent with the proper performance by the utility of its service to the public and will not impair its ability to perform that service, and is reasonable, necessary, and appropriate for such purposes.

2. Nolin is capable of executing its notes as security for the loan as stated herein.

3. Nolin should select the interest rate program which will result in the net lowest cost of money to it over the term of the financing. This should be done for the initial advance of the loan funds, and when the loan is reamortized.

4. Within 10 days of its selection of the interest rate program, Nolin should notify the Commission in writing of the interest rate program selected and of the reasons for its selection. This should be done for the initial advance of loan funds, and when the loan is reamortized.

5. The proceeds from the proposed loan should be used only for the lawful purposes set out in Nolin s application.

6. Nolin should include in its monthly financial report to the Commission the current interest rate on its outstanding variable rate loans.

7. Within 30 days of the completion of the capital credit retirements, Nolin should provide the Commission with a report showing the disposition of the loan funds. This report should indicate the total amount of capital credits paid to members for the calendar years 1995, 1996, 1997, and 1998. The report should also state whether Nolin

had to use sources other than the CFC loan to fund the retirements, identify those sources, and indicate the corresponding amounts of funding.

IT IS THEREFORE ORDERED that:

1. Nolin is authorized to borrow $4,300,000 from CFC for a 15-year period and bearing a variable interest rate as chosen by Nolin at the time the monies are drawn from CFC, subject to the provisions and terms of the application with respect to renegotiation of the interest rate.

2. Nolin is authorized to execute its notes as security for the loan authorized herein.

3. Nolin shall comply with all matters set out in Findings 3 through 7 as if they were individually so ordered.

Nothing contained herein shall be deemed a warranty or finding of value of securities or financing authorized herein on the part of the Commonwealth of Kentucky or any agency thereof.

Done at Frankfort, Kentucky, this 1st day of November, 1999.

By the Commission

ATTEST:

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Executive Director