# Capital Credits Task Force Report

## A Distribution Cooperative's Guide to Making Capital Credits Decisions

National Rural Electric
Cooperative Association

National Rural Utilities
Cooperative Finance Corporation

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# A Message from the Task Force

**Back Row** (Left to Right): James Andrews, Joe Cole, Dave Eames, Roger Yoder, R. Layne Morrill, Jack Preston, Charles Barton, Mike Bash, Bill Kopacz, John R. Smith, Charles Lopez

**Front Row** (Left to Right): Eunice Bartels, Gene Smith, Debbie Robinson

**Not Pictured** Michael Whiteside, Gary Voigt, Denise Barrera

The well-known business scandals of recent years present a challenge and an opportunity to explain why cooperatives are different from other forms of business. A cooperative's capital credits policy and practices can clearly demonstrate this authentic difference.

Establishing a capital credits policy is one of the most important responsibilities of a co-op's board of directors. It requires the board to make important decisions, not only about allocating and retiring capital credits, but also about the co-op's capital structure. This report has been developed to assist cooperatives in making these key decisions.

In December 2003, CFC and NRECA appointed the Capital Credits Task Force to conduct a study of capital credits issues and provide guidance to cooperatives. During our deliberations we reviewed extensive information on capital credits issues. We sought the advice of many experts, including lawyers, accountants, tax advisers, data processing specialists and the RUS staff. We also sought the input of other co-ops and conducted two surveys to determine practices and concerns.

Each cooperative has unique circumstances that affect its capital credits decisions, but the task force found that there are many common issues. Wherever possible, the task force has provided information about alternative approaches to these issues. We also offer our recommendations where we believe that the appropriate action is clear and applicable in most situations. The task force believes very strongly that every staff member and every co-op director should understand the co-op's capital credits policy, be able to explain it to members, and be able to answer any questions that members might have.

We urge each electric cooperative to use this report as a guide to a thorough review of its capital credits policy and practices. Such a review is worthy of each co-op's time and attention because capital credits demonstrate—in a tangible and powerful way—the cooperative difference that is central to the future success and growth of the entire rural electric cooperative network.

J.E. "Gene" Smith
*Chairman*

James Andrews | Mike Bash | Bill Kopacz | John R. Smith

Denise Barrera | Joe Cole | R. Layne Morrill | Gary Voigt

Charles Barton | Dave Eames | Jack Preston | Michael Whiteside

Eunice Bartels | Charles Lopez | Debbie Robinson | Roger Yoder

# Acknowledgments

The task force acknowledges with thanks the contributions of the experts who shared their time, knowledge and experience, including:

**Ron Camp**
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Tucker, Georgia

**Kevin Dolan**
Deloitte & Touche
Atlanta, Georgia

**Vern Dosch**
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**Thomas M. Strait**
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**Richard G. Tisinger, Sr.**
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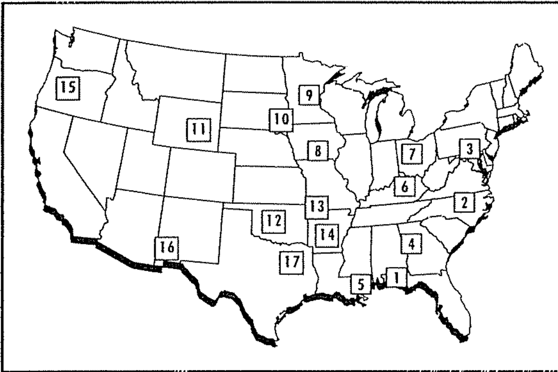
Carrollton, Georgia

Their understanding of the issues facing the electric cooperative network and their willingness to assist the task force in its deliberations is much appreciated.

Thanks also to RUS, CFC and NRECA for providing staff support for the project, including project coordinators Rich Larochelle, CFC, and Mike Ganley, NRECA; Diana Alger and Patrick Sarver, RUS; Steve Piecara, Bob Patton, and Ty Thompson, NRECA; and Lynn Midgette, Claudia Phillips, Tom Nusbaum, Marty Crowson, Jim Kaufman and Beth Ann Johnson, CFC; and to Patricia Lloyd Williams and Vicki Albizo for editorial services.

# Task Force Members

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# Recommendations of the Task Force

Following is a summary of the task force's 12 recommendations.

## Strategic Goals

**A Board-Approved Policy:** Every electric cooperative should have a policy for annually allocating capital credits and, subject to the board of directors' discretion and the cooperative's financial condition, annually retiring capital credits.

**Equity Management Plan:** Every electric cooperative should develop and implement an equity management plan that supports its capital credits policy based on the co-op's equity and debt requirements, financial performance and competitive situation. The equity management plan should include rates that will generate adequate cash to provide capital credits retirements.

**Adequate Equity Level:** Each electric cooperative should seek to maintain an equity level adequate to retire capital credits on an annual basis and meet the goals and requirements of its equity management plan. The task force suggests that a reasonable equity level for most distribution systems is in the range of 30 to 50 percent, depending on the cooperative's financial and competitive situation.

**Permanent Equity:** The development of permanent equity should not be a goal of a cooperative's capital credits policy. Any advantages of permanent equity, such as building a cooperative's equity level or developing reserves, can be achieved in more direct ways that do not involve the same tax, takeover or other risks inherent in a policy of permanent equity.

## Allocating Capital Credits

**Member Notification:** Cooperatives should notify members in writing of the dollar amount of annual capital credits allocations.

**Contractual Forfeiture:** Electric cooperatives should not enter contracts that require members to forfeit the right to capital credits in return for other considerations, such as reduced rates.

## Retiring Capital Credits

**Selecting Retirement Method Based on Goals:** Each cooperative should choose a retirement method that will help the co-op achieve its goals, recognizing the effect the tenure and age of its members has on the perception of the value of membership in the cooperative. The task force strongly recommends that each cooperative know the percentage of its current membership receiving a capital credits retirement each year and seek to maximize that percentage.

**Discount Special, Not General, Retirements:** If an electric cooperative chooses to make special retirements, such as retirements to estates, the amount of the retirement should be discounted to reflect the time value of money. Cooperatives should not offer discounted general retirements.

**Recommended Discount Rate:** If a cooperative makes discounted capital credits retirements, the task force suggests that the discount rate selected should be based on the cooperative's weighted cost of capital, which includes the cost of equity and the cost of debt.

**Age of Members:** Electric cooperatives should not make special capital credits retirements based solely on the age of the member.

### Compliance

**Director Flexibility and Discretion:** Every electric cooperative should review its bylaws, state laws and other applicable governing factors in terms of the impact on capital credits policies. If a cooperative's bylaws do not permit the board to exercise sufficient discretion regarding the method for allocating or retiring capital credits, the cooperative should consider seeking changes to give directors such flexibility in determining capital credits policies.

### Maximizing the Benefits of Capital Credits Decisions

**Communications Plan:** Every cooperative should have a communications plan for educating members about capital credits and the cooperative's capital credits policies. Every director and each employee should understand the policy and be able to explain how it works and why it was adopted to members who have questions.

# Executive Summary

In 1976, the first Capital Credits Study Committee issued a comprehensive report addressing many questions concerning capital credits. While the information in that report continues to be valid, since that time there have been many new developments, such as:

- Demographic changes among cooperative consumers,
- An increase in the use of discounting of capital credits retirements,
- Interest in developing permanent equity,
- An increased awareness of alternative retirement methods that may better demonstrate cooperative value to today's consumers, and
- Diversification into additional services.

In December 2003, the NRECA and CFC boards of directors appointed the Capital Credits Task Force to conduct a new capital credits study. The 17-member task force includes seven CEOs, five CFOs and five directors from co-ops representing the diversity of the electric cooperative network in terms of size and geographic location. It includes representatives from generation and transmission (G&T) cooperatives and distribution cooperatives.

In addition to reviewing the extensive information already available on capital credits, the task force enlisted the assistance of legal, tax, finance and accounting experts as well as the RUS staff to advise it on relevant issues. It sought and received input from the cooperative network through many channels, including separate surveys of distribution cooperatives and G&T cooperatives to identify their current practices and concerns.

While every cooperative has unique circumstances that affect capital credits decisions, the task force found many common issues. In its report, the task force addresses basic issues, evaluates alternative approaches and guides the co-op through the process of establishing a comprehensive policy.

## Capital Credits Basics

Capital credits are the primary source of equity for most cooperatives, and allocating and retiring capital credits are two of the practices that distinguish cooperatives from other businesses. In 2003, electric distribution cooperatives returned $351 million in general capital credits retirements to consumers and $94 million in special retirements, primarily to estates.

Adopting and implementing a capital credits policy are key responsibilities of a co-op's board of directors and management. As the elected representatives of the members, directors must understand the co-op's capital credits policy and be able to explain why it was adopted and how it works to members who have questions. Management and staff are responsible for executing the board's policy. In doing so, a cooperative will face important decisions, including:

- What funds will be allocated to members,
- How funds will be allocated,
- How members will be notified of their allocations,
- What amount of capital credits to retire each year,
- Which retirement method to use,
- Whether to make special retirements,
- Whether to discount any retirements and, if so, the discount rate to use, and
- Which approach to retiring capital credits will maximize the value for the co-op and its members.

The board should also establish an equity management plan to support capital credits policies that allows it to balance equity and debt effectively to meet a variety of financial needs and criteria, including:

- Maintaining financial strength,
- Meeting mortgage requirements,
- Funding new construction,
- Retiring capital credits, and
- Ensuring fairness across generations.

### Allocating Capital Credits

To qualify for federal tax-exempt status under Internal Revenue Code (IRC) Section 501(c)(12), a co-op generally must allocate capital credits to patrons each year and maintain records sufficient to reflect the equity of each member in the assets of the cooperative. State statutes and regulations and the cooperative's bylaws may impose additional allocation requirements and restrictions.

Audit guidelines issued by the Internal Revenue Service require a cooperative to allocate operating margins. Depending on circumstances, the board may have some discretion in choosing whether to allocate other patronage-sourced margins, non-patronage sourced margins or losses.

Co-ops may allocate capital credits on a variety of bases, provided that the basis is fair and equitable to patrons, including:

- Value (dollar amount of purchases),
- Quantity (kilowatt-hours or other measure), or
- Cost of service (contribution to margins).

A cooperative may use different allocation methods for different customer classes, but the same method must be used for all customers within a class.

A co-op must keep adequate records of each member's rights and interests in the cooperative's assets, including capital credits balances and a history of patronage. A co-op cannot terminate a member's rights and interests if the member moves or otherwise terminates membership, so the co-op must maintain records for former members until their capital credits are retired.

There are no requirements under Section 501(c)(12) for an exempt co-op to notify patrons of capital credits allocations, although many choose to do so, and the Capital Credits Task Force specifically recommends such annual notification as an important best practice. A taxable cooperative is required to give each member a written notice of the specific dollar amount within 8 1/2 months from the end of the co-op's tax year in order to claim a patronage dividend exclusion against its patronage-sourced margins.

### Retiring Capital Credits

There are good business reasons to retire capital credits. It provides tangible evidence of members' ownership in the cooperative and demonstrates the difference between cooperatives and other organizations. Since the funds members invest in the cooperative do not earn dividends or other financial remuneration, retiring capital credits is a way to ensure that each generation of members pays its own way by providing its own equity. Failure to retire capital credits can have a negative impact on public relations and even lead to litigation or a hostile takeover if unhappy members try to recover their investment in the cooperative.

There are also legal reasons to retire capital credits in order to preserve a cooperative's status under the tax laws, but the IRS and the courts give cooperative boards considerable discretion in determining when to retire capital credits.

The board determines whether the co-op is in a financial position to retire capital credits and, if so, the dollar amount to retire in a given year. That decision is influenced by a number of factors, including:

- The co-op's financial performance,
- Its equity management plan,
- Rate competitiveness, and
- Regulatory bodies.

Other considerations include lender requirements and the views of the financial markets, both of which influence the cooperative's ability to obtain funds in the future. The board may choose to retire a percentage of the previous year's margins, capital credits allocated for specific years or a specific dollar amount.

Unless the bylaws or other authority specify retirement procedures, the board decides how capital credits are returned. In determining a method, the board should consider factors such as:

- **Cooperative philosophy.** Who should provide equity to the co-op, current and newer members or longer-term and former members?
- **Membership expectations.** Do the members expect to receive a retirement every year?
- **Demographics.** Is the membership of the cooperative stable, or is the rate of turnover high?
- **Customer classes.** Are sales predominantly to residential consumers, or are there significant sales to commercial customers?
- **Cooperative's accounting procedures.** Can the cooperative's accounting system and data service provider easily implement the method chosen?
- **Sellout exposure.** Could failure to retire capital credits lead to internal or external pressure to sell the cooperative?

Common retirement methods for general retirements include:

- First-in, first-out (FIFO),
- Percentage of total allocated capital credits,
- Percentage/FIFO hybrid, and
- FIFO/Last-in, first-out (LIFO) hybrid.

While FIFO continues to be the most commonly used method, the use of hybrid approaches is increasing because they provide benefits to current consumers. The Capital Credits Task Force recommends that before a cooperative retires capital credits in any year, it should know the percentage of its current members that will receive a capital credits refund, and select a retirement method or hybrid of methods that will maximize that percentage.

The board may decide as part of its policy to authorize special retirements of capital credits to recognize special circumstances, such as the death of a member. A special retirement allows the cooperative to make a payment sooner than it otherwise would. However, there is a real cost to the other members of the cooperative to retire capital credits out of sequence, and there is a benefit to the member to receive money sooner than the member would otherwise. Discounting special retirements to reflect the time value of money provides a fair way to recognize special circumstances while continuing to treat members equitably.

If a cooperative elects to discount capital credits retirements, the board must then choose the appropriate discount rate. It is important that the board consider this issue carefully, because the discount rate is the key to making discounted retirements fair and equitable. Too high a rate penalizes the member. Too low a rate penalizes the cooperative and its remaining members.

There is no one standard that is appropriate for every cooperative in every situation. The measure chosen should be easy to calculate, easy to explain and defensible. It should be fair to members both individually and collectively. The Capital Credits Task Force recommends that cooperatives use their own weighted average cost of capital as the discount rate.

### Compliance Issues

A cooperative's policy for allocating and retiring capital credits must comply with applicable state and federal laws as well as the co-op's articles of incorporation and bylaws. The policy should also take into consideration the requirements of lenders and the financial markets. Directors should understand the legal and financial consequences of decisions they make about capital credits.

### Maximizing the Benefit of Capital Credit Retirements

The act of distributing capital credits retirements offers an opportunity to address the special value of co-op membership. Basic knowledge of the characteristics of its membership, especially the age and tenure of members, can help a co-op devise capital credits policies and communications programs that will maximize the benefit of capital credits retirements.

A well-designed communications plan can help members understand what they are receiving. Communications materials should answer questions from the member's perspective, such as:

- What are capital credits?
- Why is it important for electric cooperatives to allocate and retire capital credits?
- How do capital credits benefit the cooperative and membership?
- Who receives capital credits allocations?
- When and how are capital credits returned?

In addition to written materials, the Capital Credits Task Force recommends that cooperatives take the time and devote the effort to ensure that every co-op employee and every co-op director understands the co-op's capital credits policy and is able to explain it to co-op members.

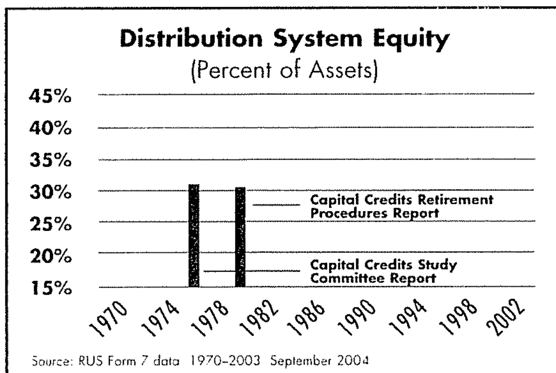
Thoughtful timing and the method of the distribution can maximize the benefit of that communication. The best approach for an individual co-op depends on what it wants to accomplish, demographics and the size of the distributions. For example, the co-op may issue retirements at a time when members will appreciate extra money or when the cooperative wants to draw attention to cooperative principles. The co-op can issue the retirement as a check or bill credit effectively, depending on its goals and communications plan.

Members, nonmembers and the public respond very favorably to the concept, principles and values that electric cooperatives offer consumers. An effective capital credits policy can help build member loyalty and educate consumers about the advantages of cooperative membership.

# Origins of the Capital Credits Task Force

Electric cooperatives were born of necessity. They have succeeded for almost 70 years because they conduct business in accordance with core principles and values that put the consumer first. The foremost goal of every electric cooperative is to deliver power reliably at a reasonable cost. Co-ops have adopted a basic set of principles to guide their efforts to achieve that goal. Returning the funds members invest in the cooperative—capital credits—to the members is an important part of the cooperative philosophy.[1]

In the early years of the rural electric program, cooperatives were seldom able to return capital credits, because systems needed to retain equity in order to meet member needs and build financial strength. By the early 1970s, however, the composite equity of electric distribution systems approached 35 percent. Yet in 1975 only 127 systems out of 1,050 borrowers reporting to the Rural Electrification Administration (REA)[2] made general capital credits retirements. Cooperative leaders recognized that it was time to address this issue. The National Rural Electric Cooperative Association (NRECA) and the National Rural Utilities Cooperative Finance Corporation (CFC) jointly commissioned the first Capital Credits Study Committee in 1974 to investigate the issues regarding capital credits and to make recommendations that cooperatives could incorporate into their own objectives, policies and programs. The committee report,[3] issued in February 1976, was the first document to address the legal, accounting and philosophical aspects of equity management, capital credits allocations and capital credits retirements in a comprehensive manner.




**Since the original capital credits studies in 1976 and 1980, co-ops have substantially increased equity levels.**

The first Capital Credits Study Committee succeeded in focusing attention on capital credits issues, but many co-ops needed more information about the procedural aspects of retirement. In 1980, the Capital Credits Retirement Procedures Task Force was appointed to evaluate alternatives and develop guidelines for co-ops considering a retirement program. The task force report,[4] issued in August 1980, provided a thorough examination of retirement issues and made 12 specific recommendations related to administering capital credits policies.

The original Capital Credits Study Committee based its deliberations on the need for member understanding and support and the financial requirements of the cooperatives.

The committee recommended that co-ops retire capital credits to emphasize the benefits of member ownership. It also emphasized the importance of maintaining financial strength in order to ensure access to capital, recommending a minimum equity level of 30 percent.

In the time since that report was completed, most cooperatives have complied with those recommendations. Analysis of the 2003 Form 7 data reported to RUS and CFC shows that the composite equity of distribution cooperatives exceeded 40 percent, and 84 percent of eligible systems were retiring capital credits.[5] Electric distribution cooperatives are now retiring more than $300 million in capital credits each year. (Additional information about trends in co-op equity and capital credits retirement levels is available online at Cooperative.com.)

Now that capital credits allocations have grown to significant dollar amounts, there are a number of reasons for taking another look at capital credits issues. For example, there have been questions about the practices of some co-ops that have accumulated significant equity but do not retire capital credits. Some co-ops face contractual, legal and regulatory challenges in retiring capital credits. Others have chosen to accumulate equity as a matter of policy.

[1] The Tennessee Valley Authority (TVA) interprets its power contracts with electric cooperatives as prohibiting the retirement of capital credits. Because of this prohibition, the information and recommendations contained in this report may not apply, or may apply differently, to electric cooperatives served by TVA. Further, because of the TVA power contract, case law in the U.S. Court of Appeals for the Sixth Circuit regarding the tax-exempt status of electric cooperatives, and the application of Internal Revenue Code (IRC) Section 501(c)(12) to mutual, as well as cooperative, organizations, the Internal Revenue Service (IRS) has accepted certain capital credits practices by TVA electric cooperatives. It is unclear whether the IRS would accept similar practices in other areas of the country.

[2] REA was the predecessor to the Rural Utilities Service (RUS).

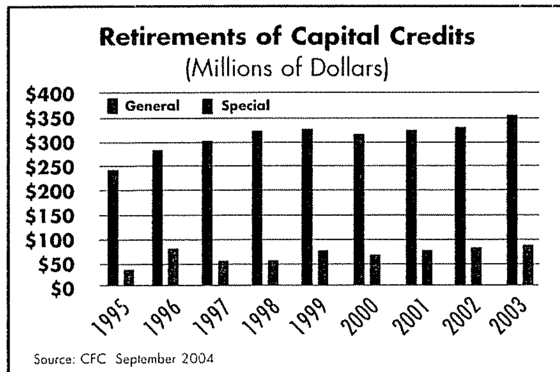
[3] *Final Report and Recommendations*, Capital Credits Study Committee, February 1976.

[4] *Capital Credits Retirement Procedures, The Report of the Capital Credits Retirement Procedures Task Force*, August 1980.

[5] The number of eligible systems does not include cooperatives served by TVA, Public Power Districts and mutual companies. As noted above, TVA has interpreted its power contracts with electric cooperatives as prohibiting the retirement of capital credits.

More and more cooperative boards are looking at their patronage capital policies and asking some very good questions, such as:

- Do current and historic policies maximize benefits to the cooperative and for its members?
- Do the co-op's practices balance the need to return capital to the members with the need to maintain the financial strength of the cooperative?




**Co-ops are retiring capital credits in significant dollar amounts.**

In addition, the demographics of some cooperative service territories have changed substantially since the 1970s studies. Some serve areas with rapid growth and a high rate of member turnover.[6] While basic capital credits tenets still apply, the practices and procedures appropriate for those co-ops may be different than those appropriate for co-ops serving stable areas with less customer turnover.

Other developments since the last studies include an increase in the use of discounting, new interest in developing permanent equity and increased awareness of alternatives to the traditional first-in, first-out (FIFO) retirement method. There also are new legal, accounting and operating issues that require attention, and many co-ops now offer diversified services.

In December 2003, the NRECA and CFC boards of directors adopted a recommendation by the NRECA issues committee to appoint a Capital Credits Task Force to conduct a new study of capital credits issues. The task force was put in place to address:

- The balance between retaining capital credits to build co-op financial strength and returning those benefits of ownership to co-op members,
- The advantages, disadvantages and legal issues associated with the various allocation and retirement methods,
- Short- and long-term trends in equity development and capital credits retirements,
- Tax and accounting considerations, and
- Legal issues arising from state and federal laws and regulations.

## Survey Results

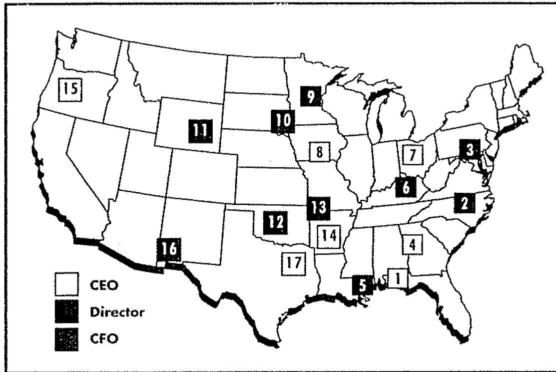
Seventy-eight percent of respondents to the task force survey say they retire capital credits annually, and 80 percent retired capital credits in 2003. The respondents also reported that on average, 72.8 percent of their current members received a retirement in 2003.

Source: *Survey Report*, Capital Credits Task Force March 9, 2004



[6] See page 65.

The 17-member task force includes seven CEOs, five CFOs and five directors from co-ops representing the diversity of the cooperative network in terms of size and geographic location. It includes representatives from generation and transmission (G&T) cooperatives and distribution cooperatives. A list of the task force members is included on page 6.




**The Capital Credits Task Force represents co-ops across the nation.**

1. Gene Smith Chairman
2. James Andrews
3. Joe Cole
4. Michael Whiteside
5. Charles Lopez
6. Dave Eames
7. Roger Yoder
8. John R. Smith
9. Mike Bash
10. Eunice Bartels
11. Jack Preston
12. Charles Barton
13. R. Layne Morrill
14. Gary Voigt
15. Bill Kopacz
16. Denise Barrera
17. Debbie Robinson

The task force has enlisted the assistance of legal, tax, finance and accounting experts to advise it on relevant issues. It has sought and received input from the cooperative network through several channels, including separate surveys of distribution cooperatives and G&T cooperatives to determine their practices and concerns. The distribution survey was sent to 885 cooperatives; 509, or 58 percent, replied. Of those responding, 78 percent retire capital credits annually, and 43 percent use the FIFO method.[7] Many co-ops report using a hybrid of two methods. Survey respondents said that the strengths associated with current policies for retiring capital credits include creating loyalty and good member relations, demonstrating the benefit of being a member/owner and consistency. Weaknesses cited include little benefit to new and current members, too much lag time, and the difficulty and expense of administering the program.

A survey of G&T systems was sent to 80 cooperatives; 30, or 38 percent, replied. Of those responding, 97 percent said they allocate capital credits with about 50 percent retiring on an annual basis. While results indicated that it is not a common practice for a G&T cooperative to collaborate with its distribution members on a capital credits plan, it is clear that directors and CEOs of distribution systems, serving as G&T directors, do influence the amount and timing of patronage retirements, providing some coordination of patronage allocation and retirement practices.

(Complete survey results are available online at Cooperative.com.)

The task force has produced this document with the hope that it will enable co-ops to consider a variety of successful practices and adopt an approach best suited for the unique requirements of their membership.

[7] See page 39.

# Chapter 1: Capital Credits Basics

## Questions for board consideration

- What are capital credits?
- How do capital credits help co-ops operate in accordance with cooperative principles?
- What are the business advantages of allocating and retiring capital credits?
- Should cooperatives convert some capital credits to permanent equity?
- What are the responsibilities of the board of directors and management regarding capital credits policies?

All business organizations need capital to operate, which is usually supplied by a combination of equity and debt. A stock company, such as an investor-owned utility, can raise equity by selling shares of stock, or ownership, in the company to the general public. Stockholders invest in the stock willingly with the expectation of earning a return on the investment through dividends and capital appreciation.

An electric cooperative generally cannot issue stock and pay dividends to the general public.[8] However, it still needs to maintain an adequate level of equity to ensure financial health and stability.

## WHAT ARE CAPITAL CREDITS?

The most significant source of equity for most cooperatives is the retention of margins from the sale of products and services.[9] These margins are allocated to patrons as capital credits based on their purchases from the cooperative, or patronage.

A cooperative's capital credits practices are grounded in cooperative principles. They are also governed by:

- Federal laws and regulations,
- State laws and regulations,
- Articles of incorporation,
- Mortgage covenants and other contractual obligations,
- Bylaws, and
- Board policies.

Other factors affecting capital credits practices include financial considerations, such as the need to balance debt and equity to maintain creditworthiness, rate competitiveness, accounting practices, and the opportunity to use capital credits to build greater awareness of the values and heritage that make co-ops unique among electricity providers.

### Keywords

**member** Any individual or entity that is entitled to participate in cooperative elections and vote and to share in patronage capital allocations.

**patron** Any individual or entity doing business with the cooperative that is entitled to share in patronage capital allocations. All members are patrons. All patrons, however, are not necessarily members. Only members are entitled to participate in cooperative elections. A cooperative also may have customers that are neither patrons entitled to share in patronage capital allocations nor members entitled to vote.

**capital credits** Margins credited to patrons of a cooperative based on their relative purchases from the cooperative. Capital credits are used by the cooperative as its primary equity base, then paid back to the membership as financial conditions permit. Capital credits reflect each member's ownership in the cooperative. Also called patronage capital or equity capital.

**allocate capital credits** To assign capital credits to members/patrons.

**retire capital credits** To pay capital credits to members/patrons either through cash, credit or property. Also called revolving, rotating or redeeming capital credits.

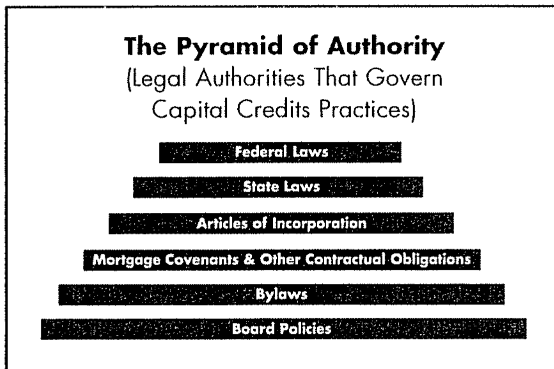
**rotation period** The period of time that capital credits are held by the cooperative before being returned to members. For example, a co-op retiring capital credits using the first-in, first-out (FIFO) method and a 20-year rotation period would return capital credits allocated in 1984 in 2004.



[8] A few co-ops have suggested converting capital credits to preferred stock with a dividend of up to 8 percent in order to establish a permanent pool of equity (see page 19).
[9] Other potential sources of co-op equity include items such as member fees and unallocated accumulated non-operating margins.

## HOW DO CAPITAL CREDITS HELP CO-OPS OPERATE IN ACCORDANCE WITH COOPERATIVE PRINCIPLES?

The International Cooperative Alliance (ICA), an association that serves all kinds of cooperatives worldwide, has identified basic values shared by all co-ops: "Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of their founders, cooperative members believe in the ethical values of honesty, openness, social responsibility and caring for others."[10] The ICA has adopted seven principles to guide co-ops in putting these values into practice. Adherence to these principles is one of the characteristics that distinguish cooperatives from other electricity suppliers.




Membership in an electric cooperative is open to anyone who is able to purchase electric service through the cooperative and is willing to accept the responsibilities of membership. Each member also is an owner of the cooperative. As owners, the members want to see that the cooperative maintains good financial health. Maintaining adequate equity is part of the board of directors' responsibility.

Member-owners control the cooperative by approving matters affecting the governance of the co-op and by electing members to serve on the board of directors. The board is accountable to the membership for the cooperative's operations and results. This keeps operations focused on meeting member needs, and it also obligates the members to elect directors who make sure the cooperative maintains fiscally sound operations.

Members have an economic stake in the cooperative. By acting together through the cooperative, members can obtain services that might otherwise not be available and achieve the advantages of economies of scale and bargaining power. They have an obligation to pay rates sufficient to meet the co-op's operating expenses and financing needs, to provide for growth and to provide margins to meet equity goals. Members are also entitled to a return of their equity investment, at some point, in proportion to their use of services from the cooperative.

Electric cooperatives implement cooperative principles by, among other things, allocating capital credits to members each year and by retiring capital credits when authorized by the board of directors as the co-op's financial situation allows. In devising a capital credits policy, it is important to remember that capital credits are an investment in the cooperative that should ideally be returned to the member on a reasonable, systematic basis.

### Seven Principles Distinguish Co-ops from Other Electric Suppliers

1. **Voluntary and Open Membership** Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

2. **Democratic Member Control** Cooperatives are democratic organizations controlled by their members who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary cooperatives, members have equal voting rights (one member, one vote) and cooperatives at other levels are organized in a democratic manner.

[10] *Statement on the Cooperative Identity*, adopted at the 1995 Congress and General Assembly of the International Cooperative Alliance.

3. **Member Economic Participation** Members contribute equitably to, and democratically control, the capital of their cooperative. At least part of that capital is usually the common property of the cooperative. The members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing the cooperative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the cooperative; and supporting other activities approved by the membership.

4. **Autonomy and Independence** Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy.

5. **Education, Training and Information** Cooperatives provide education and training for their members, elected representatives, managers and employees so they can contribute effectively to the development of their cooperatives. They inform the general public—particularly young people and opinion leaders—about the nature and benefits of cooperation.

6. **Cooperation Among Cooperatives** Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, regional, national and international structures.

7. **Concern for Community** While focusing on member needs, cooperatives work for the sustainable development of their communities through policies accepted by their members.

## WHAT ARE THE BUSINESS ADVANTAGES OF ALLOCATING AND RETIRING CAPITAL CREDITS?

Research shows that most consumers judge a cooperative on the basis of its quality of service and reasonableness of rates. A sound capital credits policy can help a cooperative improve member perception of its performance in these areas and distinguish it from other service providers. Research shows that returning capital credits to consumers contributes significantly to their perception of receiving good value as well as increasing their sense of membership. It can help a co-op connect with members in a way that contributes to satisfaction and customer loyalty.

**Reduced cost of doing business** Capital credit allocations help a cooperative qualify for cooperative status under federal income tax law, thus eliminating or reducing income tax liabilities and the associated costs.

**Reduced net cost of electricity for members** Capital credit retirements offset a portion of the costs consumers pay through electric rates.

**Member education and public relations benefits** A co-op member who receives a capital credits retirement receives a tangible reminder of the values and heritage that make cooperatives unique among electric providers.

**Reduced vulnerability to takeover and sellout attempts** Members who realize tangible benefits from cooperative ownership are more likely to resist takeover attempts, while failure to retire capital credits may provide an incentive for sellout.

**Learn from Experience**
**Boone EC Educates the Educated**

In the bustling university town of Columbia, Missouri, Boone Electric Cooperative knows it needs to think out of the box when it comes to educating its members about the cooperative way of doing business.

Home to three major universities and colleges, including University of Missouri's main campus, this 27,000-meter co-op disconnects and reconnects about 8,000 meters every year. "We have an extremely high volume of transient members," says Boone EC General Manager and CEO Roger Clark. "In the short time that many of them are here, it is a daily challenge to find creative ways of helping them see the benefits of cooperative membership."

One way Boone tackles this challenge is by using a LIFO/FIFO hybrid to retire its capital credits. "Last year we had such a good year—primarily weather driven—that we were able to retire $3 million," Clark says. "We returned $2 million in current-year margins and $1 million in old margins. Since margins were so high this year, we decided to retire a higher percentage than usual—which is typically a 50/50 split."

Boone mails notices to its members at the end of March letting them know their portion of the capital credits allocation. In mid-December, just before the holidays, they send capital credits checks to qualifying members. "We know it costs more to send checks, but we believe the money is well spent. These checks are the best way for us to tell the cooperative story," Clark says. "Many times we'll get calls from members asking why they received a check—there is no better opportunity for us to explain what makes us different and what it means to them to be a member." He said one member even sent a special thank-you note to the co-op for her capital credits check. "This member told us that she wouldn't have been able to buy Christmas presents for her children without it."

When it comes to reviewing its capital credits policy, Boone says it's an ongoing process. "Our board and staff use the three-legged-stool approach—we look at where we want rates to be, where we want our equity and financial ratios to be, and how we can best meet our capital credits retirement goal for the year," Clark says. "We do this planning with the help of our 10-year financial forecast. It helps us to keep a healthy balance and ease into where we want to be down the road."

Boone is making big strides in a big college town. "Last year, for the first time, we ran an ad about our capital credits payout in the *Columbia Daily Tribune*. This got the attention of members and non-members alike," Clark says. "Customers of the local municipal utility wanted to know why they weren't getting checks from their utility!"

It's all about education at this university town co-op.

## SHOULD COOPERATIVES CONVERT SOME CAPITAL CREDITS TO PERMANENT EQUITY?

One emerging issue is whether there is a need for cooperatives to create a pool of permanent equity not allocated to the members as capital credits. In some cases, permanent equity results from a business decision made for other reasons. For example, when a cooperative retires capital credits to an estate at a discount, the cooperative assumes ownership of the difference between the total allocation and the amount retired.[11] The decision to make that retirement was likely based on the mutual benefits to the cooperative and the member's estate. In another example, a cooperative may choose to not allocate an extraordinary gain for which it receives no cash. The decision is likely based on cash requirements rather than a desire to create additional equity.

Some cooperatives, however, have considered accruing permanent equity as a matter of policy. Whether to do so is a fundamental strategic decision. It represents a basic change in interpretation of cooperative principles. It also may require changes in allocation and retirement decisions.

[11] In some cases, the IRS has allowed cooperatives to reallocate the difference to remaining members of the cooperative. In other cases the IRS has denied this approach.

There are at least three potential sources for funding permanent equity:

- Non-patronage-sourced margins,[12]
- The amounts remaining after discounted special retirements,[13] and
- The amounts remaining after discounted general retirements.[14]

If a co-op chooses to develop permanent equity, its capital credits policies will determine the level that can be reasonably attained and how quickly it will be reached.

Those who favor developing permanent equity say that it:

- Provides permanent reserves,
- Allows the co-op to rotate operating margins more quickly, and
- Improves a co-op's credit profile when implemented in conjunction with a sound equity management plan.

In addition, permanent equity may provide capital for investing in diversified goods or services to meet member and community needs—when a cooperative may lawfully do so. Further, if an electric cooperative loses its federal income tax exemption, then retaining non-patronage-sourced, non-operating margins prevents the cooperative from being in the unenviable position of paying tax on these margins and having allocated them.

Those who oppose creating permanent equity say that it is not necessary because the same goals can be achieved through other means. In addition, adopting the practices that create permanent equity may appear to consumers to be unfair and contrary to cooperative principles.

Co-ops can manage their balance sheets without permanent equity because capital credits retirements are discretionary. The board determines when, how and how much to retire. If a co-op has a low level of equity overall, some say accumulating permanent equity can be an option for reaching an adequate equity level in a reasonable time frame. With an appropriate equity management planning process, however, the board can achieve the same thing by adjusting its capital credits retirement schedule. If a co-op already has a high level of equity, it probably would not benefit from developing permanent equity. If funds are needed for a special purpose, the co-op can establish a reserve for that purpose.[15]

In considering the issues associated with permanent equity, it is important to remember that a cooperative's equity does not belong to the cooperative. It belongs to its members. To the degree that an equity contribution becomes permanent, it now belongs to all members instead of an individual member. By creating permanent equity, the co-op may be creating an incentive for sellout as the members may perceive that their best option for getting their money back is to sell the cooperative.

**Recommendation**
Permanent Equity

The development of permanent equity should not be a goal of a cooperative's capital credits policy. Any advantages of permanent equity, such as building a cooperative's equity level or developing reserves, can be achieved in more direct ways that do not involve the same tax, takeover or other risks inherent in a policy of permanent equity.



[12] See page 24
[13] See page 47
[14] See page 47
[15] See page 35

Some electric co-ops have proposed converting capital credits to preferred stock bearing a dividend of up to 8 percent as a means of creating permanent equity. IRS Publication 557[16] states that cooperatives that are tax-exempt under Section 501(c)(12) may not issue stock that pays a dividend. The IRS has, however, acknowledged in an information letter that electric co-ops may have preferred stock but has refused to issue advanced rulings approving any particular terms and conditions for such an issuance. Whether the amount of stock issued would violate the subordination of capital principle would have to be determined on audit. In addition, many state electric cooperative acts require co-ops to operate on a non-profit basis, which in most cases precludes paying dividends on shares of stock issued to members. From a financial perspective, preferred stock is an expensive source of capital, particularly compared to debt and internally generated funds.

Depending on the source of the permanent equity, the co-op also may incur significant costs in terms of time and money in obtaining the legal and IRS rulings necessary to establish permanent equity. Creating permanent equity through discounting also may create taxable income. A cooperative considering this approach should consult its tax experts regarding approaches that will avoid creating taxable income.

In considering a policy to create permanent equity, the board must compare the potential costs and benefits with similar results that can be obtained through other means. There may be occasions when a cooperative has a unique need or opportunity that results in permanent equity, for example, as a result of retaining unclaimed capital credits; not allocating non-patronage-sourced, non-operating income; or discounting capital credits retirements. This approach may have value, but, depending on the source of permanent equity, the process may be complicated by state enabling statutes and potential federal tax liabilities. Any system contemplating the retention of permanent capital should seek expert advice in developing and implementing such a plan.

**Directors Should Carefully Consider the Issues Before Adopting a Policy to Develop Permanent Equity**

| Arguments in Favor of Permanent Equity | Arguments Against Permanent Equity |
|---|---|
| • Provides permanent reserves<br>• May allow co-op to rotate remaining patronage capital more quickly<br>• May improve credit profile<br>• May reduce requirements for keeping records<br>• May be best alternative for treating extraordinary gains<br>• May provide capital for diversified goods and services<br>• Avoids allocation and taxation of non-patronage-sourced, non-operating margins | • Requires fundamental change in interpretation of cooperative philosophy and may require a change in bylaws<br>• May appear to members to be inconsistent with cooperative principles<br>• Could result in non-member taxable income<br>• Costs more than other sources of capital<br>• May create incentive for sellout<br>• May achieve same results more easily and less expensively through other means |

## WHAT ARE THE RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT REGARDING CAPITAL CREDIT POLICIES?

A co-op's board of directors and management have a responsibility to establish and periodically review the co-op's capital credits policy. The board's role is strategic in scope. It establishes a vision and basic principles for the cooperative. As the elected representatives of the members of the cooperative, directors must also understand the capital credits policy and be able to explain to members why it was adopted and how it works. Management and staff are responsible for developing and implementing procedures that will achieve the board's vision.

[16] IRS Publication 557, *Tax-Exempt Status for Your Organization* (Rev. May 2003)

The process for establishing a capital credits policy is complex, and the board must make decisions about many issues, including:

- What funds will be allocated to members,
- How funds will be allocated,
- How members will be notified of their allocations,
- What amount of capital credits to retire each year,
- Which retirement method to use,
- Whether to make special retirements,
- Whether to discount any retirements and if so, the discount rate to use, and
- What approach to retiring capital credits will maximize the value for the co-op and its members.

In making these decisions, the board should be guided by the answers to two fundamental questions:

- What are the co-op's strategic goals for its capital credits policy?
- What techniques for allocating capital credits, retiring capital credits, refunding capital credits to members and communicating with members about capital credits will be most effective in helping the co-op achieve these goals?

The board must achieve all this while complying with applicable laws, regulations and the co-op's own bylaws. In some cases, a legal authority dictates the approach that must be taken. In other cases, the board has discretion to choose among alternatives, and the co-op's goals will determine the approach. These decisions are interrelated in that a decision on one issue may have consequences for another. Allocation, retirement, compliance and communication issues are discussed in greater detail in other sections of this report.

It is also important that the policy be supported by sound financial management. Each co-op should have an equity management plan that allows it to balance equity and debt effectively to meet a variety of financial needs and criteria, including:

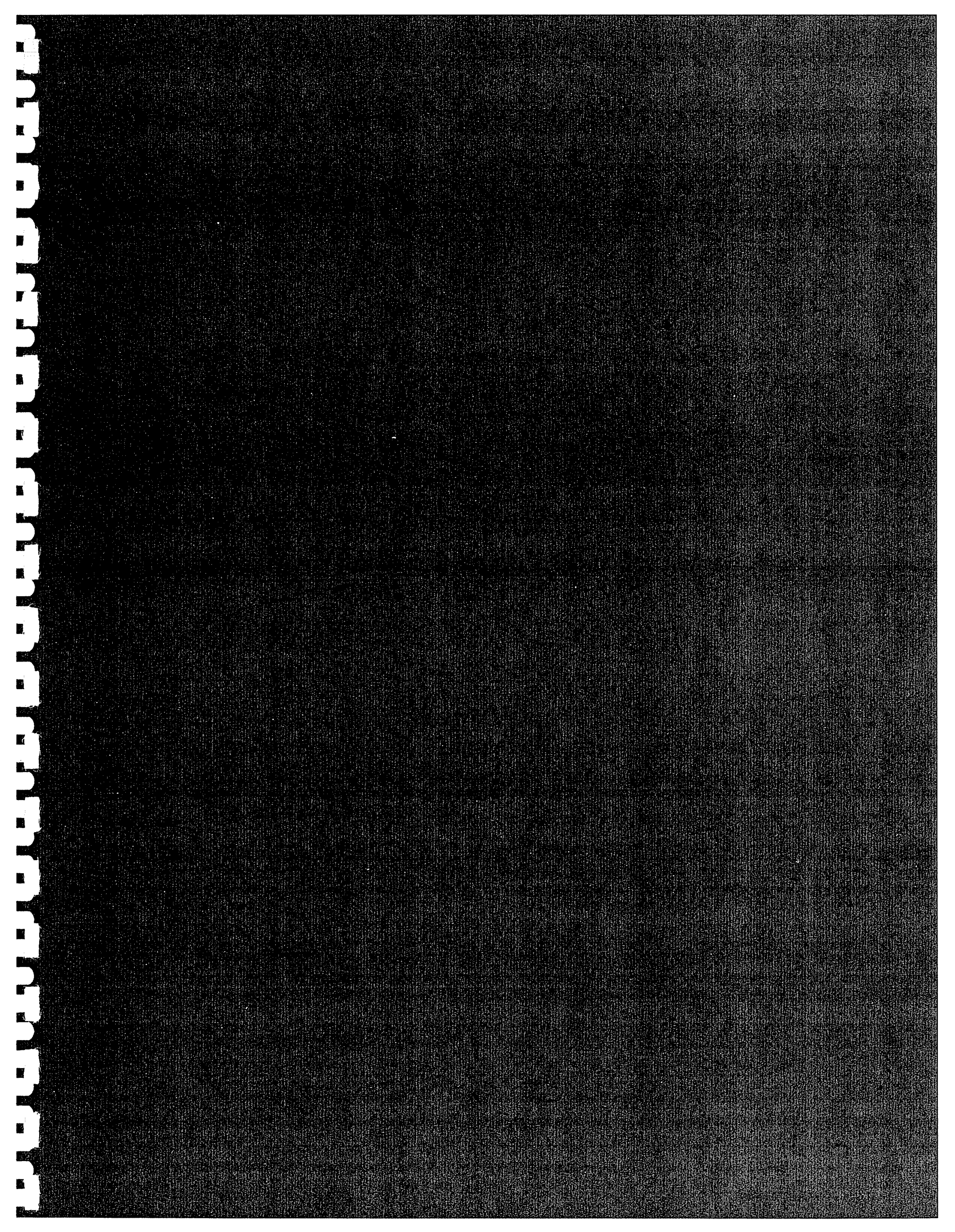
- Maintaining financial strength,
- Meeting mortgage requirements,
- Funding new construction,
- Retiring capital credits, and
- Ensuring fairness across generations.

The information provided in this report can help co-ops understand the legal, accounting and financial issues affecting capital credits policies so that these goals are met. It is also important that a cooperative seek the advice of its own legal, accounting and tax consultants when reviewing and formulating policies. In the end, however, it is up to the board to evaluate information from all sources and make an independent decision on capital credits policies.

**Recommendation**

A Board-Approved Policy

Every electric cooperative should have a policy for annually allocating capital credits and, subject to the board of directors' discretion and the cooperative's financial condition, annually retiring capital credits.



# Chapter 2: Allocating Capital Credits

## Questions for board consideration

- What funds will the co-op allocate to members as capital credits?
- Should the co-op allocate non-operating margins?
- Should the co-op allocate losses?
- How should the co-op treat capital credits from affiliated organizations?
- On what basis should co-ops allocate capital credits?
- Can the co-op require a contractual forfeiture of rights to capital credits from some members?
- How should a co-op that offers multiple services allocate capital credits?
- Is the co-op keeping adequate records of each member's rights to capital credits?
- Is the co-op providing adequate notification to members of their capital credits allocations?
- When does a member's right to capital credits vest?

To qualify for federal tax-exempt status under Internal Revenue Code (IRC) Section 501(c)(12),[17] a co-op generally must allocate capital credits to patrons each year and maintain records sufficient to reflect the equity of each member in the assets of the cooperative. State statutes and regulations and the cooperative's bylaws may impose additional allocation requirements and restrictions.

Section 501(c)(12) requires cooperatives to operate at cost with respect to its exempt purposes. For most electric distribution cooperatives, the exempt purpose will be providing electricity to patrons, unless the co-op engages in one or more "like activities" on a cooperative basis. That means that any excess of operating revenues collected over operating expenses from the provision of electricity must be allocated to patrons as capital credits, based on their participation, and ultimately returned to patrons.[18] Additionally, the allocation of patronage capital must be subject to a pre-existing obligation and must be fair and equitable on the basis of patronage. While cooperatives may retain capital credits for a period of time to meet equity needs, Section 501(c)(12) generally requires a cooperative to allocate and assign capital credits to patrons each year and to maintain records of such allocations. Capital credits should be accounted for in a way that reflects the rights and interests of members in the net savings of the cooperative. These rights and interests must be protected and not forfeited.

It is important to note that the allocation reflects members' ownership, which will be redeemed at a future date determined by the board.[19]

### Keywords

**operating margins** Revenues derived from the co-op's marketing, purchasing or providing electric and other qualifying tax-exempt services, as well as other revenues derived from utilization of the co-op's electric and other plant assets, less the expenses incurred to supply those services.

**non-operating margins** Income (revenues less related expenses) derived from non-electric products, services and/or investments.

**patronage-sourced margins** Revenues resulting from transactions that directly facilitate accomplishing the co-op's marketing, purchasing or service activities, less the expenses incurred to generate those revenues.

**non-patronage-sourced margins** Revenues resulting from activities that are not substantially related to the accomplishment of the co-op's marketing, purchasing or service activities less the expenses incurred to generate those revenues.

(Note: Accountants use the term margins and income interchangeably. Cooperatives tend to prefer the use of margin, as the word income can suggest profit.)

### Survey Results

The task force survey found that some co-ops choose not to allocate some margins.

| Item | Percent Not Allocating |
|---|---|
| Subsidiary or diversification accrued non-operating margins | 30% |
| Non-cash non-operating margins | 22% |
| Unbilled revenue or other similar accrued operating margins | 21% |
| Inactive accounts with relatively small patronage | 10% |

Source: *Survey Report,* Capital Credits Task Force. March 9, 2004



[17] When this report refers to requirements under 501(c)(12), it is referring to case law interpreting requirements for co-ops organized under 501(c)(12).
[18] TVA interprets its power contracts with electric cooperatives as prohibiting the retirement of capital credits. Because of the TVA power contract, case law in the U.S. Court of Appeals for the Sixth Circuit regarding the tax-exempt status of electric cooperatives and the application of IRC 501(c)(12) to mutual, as well as cooperative, organizations, the IRS has accepted certain capital credits practices by electric cooperatives served by TVA. It is unclear whether the IRS would accept similar practices in other areas of the country.
[19] For more information about the nature of capital credits, see page 16. For more information about the retirement of capital credits, see page 34.

**Uniform System of Accounts Versus Tax Regulation**

**The RUS Uniform System of Accounts and the FERC Uniform System of Accounts assign specific accounts for operating and non-operating margins. Cooperatives that are not RUS borrowers and are not subject to FERC jurisdiction prepare financial statements in accordance with generally accepted accounting principles, or GAAP; the income accounts are similar to those of the RUS and FERC systems. Unfortunately, tax regulations are based on patronage-sourced margins and non-patronage-sourced margins. The definitions of patronage- and non-patronage-sourced margins have been determined by federal courts. Operating margins are generally considered patronage-sourced; however, non-operating margins may be either patronage-sourced or non-patronage-sourced income. Some examples as determined by court decisions include:**

| Patronage-sourced Income | Non-patronage-sourced Income |
|---|---|
| • Operating margins, except for operating margins related to the sale of electric energy to non-member, non-patrons<br>• Patronage refunds from other cooperatives<br>• Interest income from short-term investment of seasonal surplus cash and income from temporary excess warehouse space<br>• Interest income from loans to cooperative's chief suppliers to ensure supplies for operations<br>• Interest income from short-term capital loans to a regional supply cooperative if such loans are made from patronage proceeds temporarily in cooperative's hands | • Non-operating margins from subsidiaries<br>• Income from investments in securities<br>• Interest income from money management of excess operating funds<br>• Interest income from short-term placement of funds not immediately required for use<br>• Income from business done with or for a non-member or non-patron by a non-exempt cooperative |

## WHAT FUNDS WILL THE CO-OP ALLOCATE TO MEMBERS AS CAPITAL CREDITS?

IRS audit guidelines regarding cooperative principles require a cooperative to allocate operating margins. Tax laws, however, allow taxable cooperatives a deduction for all patronage-sourced income. Allocating all patronage-sourced income helps to minimize tax liabilities for taxable cooperatives. It is a prudent practice for tax-exempt cooperatives to allocate patronage-sourced income as well, in case the co-op is found to be taxable for a given year at a later date. For most co-ops the major source of patronage-sourced income will be operating margins.

Depending on state laws, the co-op's bylaws and other regulations, the board of directors may have the discretion to choose whether to allocate non-patronage-sourced income, such as non-operating income. Members do not receive a vested interest in any allocations until the capital credits are retired or the co-op is liquidated.[20]

[20] See page 33

**Learn from Experience**
**When Not Allocating Makes Sense**

Many co-ops follow the practice of allocating all margins as capital credits. Some state laws, however, permit co-ops to retain non-operating margins. While many co-ops choose to allocate non-operating margins as a matter of philosophy, there may be circumstances when not allocating non-operating margins makes sense.

For example, in 2001, an exchange of subsidiary assets for an equity interest in a new business created an extraordinary accrued (non-cash) non-operating margin for Adams Electric Cooperative, Gettysburg, Pennsylvania. The co-op did not allocate the paper gain because it was uncertain as to whether it would ever receive any cash receipts. Instead, it retained it as a reserve to offset potential future non-operating margin losses, should they occur, which could otherwise diminish electric operating margin allocations in the year in which they occurred. The co-op does allocate cash received from the investment as capital credits.

## SHOULD THE CO-OP ALLOCATE NON-OPERATING MARGINS?

Some co-ops have the option of not allocating non-operating margins. However, many cooperatives do so as a matter of philosophy and practicality.

One argument in favor of allocating non-operating margins is that members assume the risk of activities that produce non-operating margins. The risk may be significant in some cases, for example a non-electric business subsidiary. If there are losses, the members may have to pay higher rates to cover them. Members share in any disadvantages from these activities. Some boards, therefore, believe that members should also share in any margins or gains.

Another viewpoint is that cooperatives should not allocate non-operating margins in order to create permanent equity.[21]

There also may be occasions when it just makes sense to avoid allocating a non-operating margin, such as in the case of an extraordinary gain that does not result in cash to the cooperative. Additionally, the allocation and subsequent retirement of non-operating, non-patronage margins by a taxable cooperative may result in a taxable dividend to the patrons and may result in additional reporting by the non-exempt cooperative to the patrons.

## SHOULD THE COOPERATIVE ALLOCATE LOSSES?

Unfortunately, sometimes a board must deal with losses. Most boards are extremely reluctant to allocate losses. In addition, RUS regulations[22] prohibit distribution borrowers from allocating losses and require instead that systems accumulate and offset losses against future non-operating margins. RUS permits G&T systems to allocate losses, though the typical G&T practice is to offset losses against future gains.

Co-ops that are not RUS borrowers should have the flexibility to assign losses if that is the best option. For example, a co-op could earn positive margins on its core electric business and suffer ongoing losses in a subsidiary. If significant, the scale of the losses could prohibit the cooperative from ever retiring the capital credits allocated from electric operations. This could raise tax concerns about whether the co-op is really operating at cost in its electric business.

If a cooperative assigns a loss as a "negative allocation" for the specific year in question, then the retirement method chosen should consider this negative allocation when retiring capital credits so that, over time, the net amount of capital credits allocated to the patron is retired. The cooperative also must address how to handle any losses assigned to a patron that becomes inactive after the year of the loss and has a negative capital credits balance as a result of assignment of the loss. The ability to assign operating losses to members may require a bylaw amendment, as some bylaws require operating and non-operating losses to be offset against non-operating income.



[21] See page 19
[22] 7 CFR 1767.41 Code of Federal Regulations, Accounting Methods and Procedures Required of All RUS borrowers

### Survey Results

Sixty-seven percent of respondents to the task force survey say they allocate G&T capital credits separately from operating margins, and 30 percent say they retire capital credits derived from a G&T allocation on a different basis than other allocated margins.

Source: *Survey Report,* Capital Credits Task Force March 9, 2004

Other options for dealing with losses include:

- Canceling prior-year capital credits of members generating the loss,
- Carrying the loss forward to offset future allocations, and
- Offsetting an unallocated reserve or similar amount, such as capital not assignable to the patrons prior to the dissolution of the cooperative.

The implementation of these options also may require a bylaw amendment. Options may be used in various combinations if the amended bylaws provide this flexibility. For example, to the extent that the loss exceeds the outstanding capital credits allocated in a prior year for a loss-year patron, the board may approve carrying this excess loss forward to offset future allocations or offset such excess against unallocated reserves or similar amounts.

The goal is to handle losses in a way that ensures that the capital credits allocated and retired represent overall margins generated by patrons purchasing electricity in proportion to the business done.

## HOW SHOULD THE CO-OP TREAT CAPITAL CREDITS FROM AFFILIATED ORGANIZATIONS?

Many cooperatives receive capital credits allocations through membership in an affiliated organization, such as a G&T cooperative, a materials supply cooperative or CFC. These capital credits generally constitute patronage-sourced income even though they do not represent operating margins. It is prudent for co-ops to allocate capital credits received from affiliated organizations to their own members for tax purposes.

A cooperative has the option of developing a separate policy for allocating and retiring capital credits from affiliated organizations. It may choose a different allocation method and a different rotation period for these capital credits amounts. Some cooperatives believe a separate allocation is particularly desirable when the amount is likely to be sizeable, such as an allocation from a G&T. A separate allocation also may be desirable if the affiliated organization has a different rotation cycle from the receiving organization or if it is unlikely that the co-op will ever receive a cash retirement.

Other cooperatives prefer not to make separate allocations of capital credits received from affiliated organizations, arguing that capital credits allocations are not different from other sources of margins and that distribution systems should allocate and retire capital credits to their members without regard to the source of the margins.

**Learn from Experience**
**Defining Fairness at Union REC**

For co-ops with extremely large commercial and industrial loads, it can be challenging to ensure that these unique members—along with all other types of members—are treated fairly and equitably. Union REC in Marysville, Ohio, is faced with this issue every day in a big way—not only when it comes to setting rates, but also when it comes to retiring capital credits.

In addition to serving about 7,300 residential and commercial members in Union County, Ohio, Union REC serves the Honda of America Mfg., Inc., automobile and motorcycle facility as well as the Honda Research and Development facility. Honda has been a member of Union REC since 1979. The Honda facility—which produces 1,800 cars and 400 motorcycles a day—has brought a wealth of jobs to the central Ohio area and has contributed significantly to the overall economic health of the region. The combined automobile and motorcycle facility accounts for 69 percent of Union REC's total annual kwh sales.

"Honda is very important to the economic success of Union REC, Union County and the central Ohio area," says Union REC President/CEO Roger Yoder. "It is important to our community that we provide top-notch electric services to this important member. In our dealings with them, we must be professional, competitive, and ethical."

Union offers Honda a completely unbundled, cost-of-service based rate that includes a separate line item on their monthly invoice called "Contribution to Operating Cost," which represents Honda's contribution to margins. Union's board of trustees and staff believe that this rate approach—which provides Honda with a competitive rate while keeping margins as low as possible—is an equitable and fair way for the co-op to treat Honda and its other members. "The rate structure basically fixes the amount of margins generated by Honda and provides us with an easy method to identify and allocate Honda's margins," Yoder says. "When the board of trustees approved retiring all of 1988 capital credits and a portion of 2001 capital credits last year, Honda's amount was significant. The retirement is refunded on their invoice over a 12-month period. This method is mutually advantageous to Honda, the co-op and our members."

Previously, the margin was a product of a markup on wholesale energy and demand. "As Honda's load would increase, the margins would increase potentially to a disproportionate level compared to our other classes of members," Yoder says. "Using the fixed margin rate, the margins are not based on energy or demand charges. Therefore, kwh sales or revenues are not used to allocate capital credits to Honda, which would create an unfair allocation of capital credits compared to the other classes of members."

Union's capital credits policy is based on the premise of fairness and consistency. "We feel the capital credits process is a basic fundamental principal of our cooperative business structure and that it is important in distinguishing us from other utilities," Yoder says. "Our equity management and cost-of-service studies include generating sufficient revenues to fairly and equitably plan for the rotation of capital credits to all members."

## ON WHAT BASIS SHOULD CO-OPS ALLOCATE CAPITAL CREDITS?

Co-ops may allocate capital credits on a variety of bases, provided that the basis is fair and equitable to patrons, including:

- Value (dollar amount of purchases),
- Quantity (kilowatt hours or other measure), or
- Cost of service (contribution to margins).

The most frequently used approach is to allocate capital credits based on the value of purchases from the co-op.

**Recommendation**
Contractual Forfeiture

Electric cooperatives should not enter contracts that require members to forfeit the right to capital credits in return for other considerations, such as reduced rates.

A cooperative may use different allocation methods for different customer classes, but the same method must be used for all customers within a class. As a practical matter, it would be burdensome for most cooperatives to allocate on a cost-of-service basis to individuals in the residential class, but it might be the best option for large commercial customers.

The board should carefully consider various options before adopting an allocation basis. The IRS expects the allocation method to be fair and equitable and to be consistently applied from year to year. While it is possible to change allocation methods occasionally, the board should have a valid business purpose, other than tax avoidance, for doing so.

### CAN THE CO-OP REQUIRE A CONTRACTUAL FORFEITURE OF RIGHTS TO CAPITAL CREDITS FROM SOME MEMBERS?

Some cooperatives have considered adopting policies that allow certain members, such as large commercial or industrial accounts, to contractually forfeit capital credits in exchange for rate reductions. Some have also considered bylaw changes that deny capital credits to certain member groups or classes of members.

The goal of such practices is usually related to economic development. Large customers bring value to the community through jobs, taxes and other contributions. Co-ops justify special rates and practices as an important part of the effort to keep rates low in order to keep employers in the community, something that benefits all members, and to avoid the disruption and imbalance that can occur with large patronage capital allocations and retirements.

Contracts that deny capital credits to any members or class of members are questionable from a tax perspective and should be avoided. Under IRC Section 501(c)(12), in order to qualify as a member of the cooperative, a customer must have:

- A right to participate in management, and
- A right to share in capital credits.

If a large customer relinquishes the right to capital credits, then it is no longer considered to be a member of the cooperative, and income from the customer could have serious implications for the co-op's ability to comply with the 85-percent member income requirement of Section 501(c)(12). The IRS also could assert that the company is not operating in a cooperative manner. Asking a member to forego capital credits also is contrary to the provisions of RUS Bulletin 102-1, which says, "No patron should be asked by contract or otherwise to waive his capital credits." Additionally, Revenue Ruling 72-36[23] provides that if, under the bylaws, a member's rights and interest have been forfeited, then the organization has not operated on a mutual or cooperative basis and is, therefore, not exempt.

[23] The complete text of Revenue Ruling 72-36, 1972-1 C.B. 151 is shown on page 58.

**Learn from Experience**
**Glacier Explores Procedures for Multiple Services**

Due to changing competitive conditions in the late 1990s, Glacier Electric Cooperative, Inc., Cut Bank, Montana, began exploring opportunities to provide additional services, such as natural gas, propane, home security, Internet communications and satellite television services. The co-op's plan was to establish a different class of membership for each new service. The members of each class would share in capital credits based on the margins earned by that class and purchases made by the member under that class of service.

In January 1999, Glacier received a private letter ruling from the IRS accepting Glacier's plan for forming three operating units—an electric division for electricity, a gas division for propane and natural gas, and a communications division for satellite television, home security and Internet communications services. The ruling also accepted Glacier's plan to establish separate classes of membership, based on the services purchased from the cooperative. In addition, the ruling found that the proposed natural gas, home security, Internet and satellite services would be considered "like activities" for the purposes of the 85 percent test. A subsequent ruling qualified propane as a "like activity."

The cooperative amended its bylaws to establish four different customer classes. For a time, Glacier did provide wire Internet service to one class of members. This activity never generated any margins to distribute to the "Class D" members of the cooperative. It was decided, however, not to pursue offering other services directly to members at this time. (Glacier has subsequently invested in a company that offers Internet services, but the customers of this for-profit company are not Glacier members.) "We have been very cautious about how we proceeded," General Manager Jasen Bronec said. "At this point we have not exercised the option to do some of the things we could do."

The letter does, however, provide insight into how the IRS might view other cooperatives considering similar actions. (A copy of the ruling is available online at Cooperative.com.)

One way to achieve the same goal and comply with legal requirements for capital credits is to establish a separate customer class for target customers. The co-op can then adopt a rate for that class that generates little or no margin and allocate capital credits based on customer-specific margins. To be defensible, the rate should be based on a cost-of-service study.

## HOW SHOULD A CO-OP THAT OFFERS MULTIPLE SERVICES ALLOCATE CAPITAL CREDITS?

According to a Power Online survey of cooperative diversification activities in 2003, 93.5 percent of distribution cooperatives responding offer, or own businesses that offer, one or more services in addition to basic electric energy.[24] Some of these services are related to electric services and offered at no charge while others are not. In some cases, the services are offered on a for-profit basis. If a co-op provides services in addition to electricity, it is important to consider the ramifications for capital credits policies.



[24] *Power Online Diversified Services Survey, 2003*

**Recommendation**
Member Notification

Cooperatives should notify members in writing of the dollar amount of annual capital credits allocations.

Cooperatives should be aware that the Section 501(c)(12) requirement to operate at cost demands that co-ops account separately for the costs and expenses associated with each service provided in order to avoid cross-subsidization of services. Cross-subsidization also may raise issues with respect to the state public service commission requirements, unrelated business income taxes (UBIT) and unfair competition. It is important that the board adopt a policy that is fair, equitable and consistently applied from year to year.

Accounting for capital credits for multiple services offered on a cooperative basis can impose a substantial administrative burden on the co-op. In at least one private letter ruling, issued to Glacier Electric Cooperative, Cut Bank, Montana, in 1999, the IRS allowed a co-op to combine similar services into one allocation pool, provided that:

- Patrons of one service are also patrons of the other services in the pool;
- The co-op's articles of incorporation, bylaws or written policies specify the composition of the pool and how capital credits are to be allocated;
- The co-op notifies the members of each pool of the risks and benefits of combining the services into one pool;
- A majority of the co-op's members agree to the pool; and
- Members periodically approve the pooling agreement.[25]

For example, an electric co-op that offers telecom services might be able to combine local, long distance and Internet service in one pool for allocation purposes. It would probably not be able to combine electric and telecom services in one pool.

The co-op may adopt different retirement methods and cycles for different allocation pools. Additionally, losses from an allocation pool would be handled in accordance with the methods provided in the bylaws and board policies. The method would be applied to the allocation pool with the loss.

## IS THE CO-OP KEEPING ADEQUATE RECORDS OF EACH MEMBER'S RIGHTS TO CAPITAL CREDITS?

A co-op must keep adequate records of each member's rights and interests in the cooperative's assets. In addition to capital credits balances, the records should include a history of patronage in order to allocate gains on appreciated assets and to distribute any assets (i.e. net savings of an organization) remaining after liabilities are paid if the cooperative is dissolved. A co-op cannot terminate a member's rights and interests if the member moves or otherwise terminates membership, so the co-op must maintain capital credits information and contact information if possible for former members. The co-op can shift some of the burden to

[25] Michael Seto and Cheryl Chasin, *General Survey of IRC 501(c)(12) Cooperatives and Examination of Current Issues*, which is available on Cooperative.com.

departing members by asking that they notify the co-op of future address changes. It can also be argued that there is a standard of reasonableness and that maintaining records for a lengthy period of time, such as 20 years, is adequate. Whether this argument is acceptable to the IRS and other authorities is uncertain.

Maintaining these records and keeping track of former customers can be costly and burdensome, particularly for co-ops operating in service territories with high rates of customer turnover.

The United States Postal Service provides a variety of services designed to assist users in tracking customer address changes, including the National Change of Address program.[26]

Individual states may impose specific requirements for keeping records and for publishing public notices of capital credits in unclaimed or escheat situations.

## IS THE CO-OP PROVIDING ADEQUATE NOTIFICATION TO MEMBERS OF THEIR CAPITAL CREDITS ALLOCATIONS?

Another decision the board must make is whether to give members an annual written notice of capital credits allocations, and if so, what type of notice to provide. There are no requirements under Section 501(c)(12) for an exempt co-op to notify patrons of capital credits allocations, although most choose to do so.

A taxable or nonexempt cooperative, one that fails the 85-percent test, is required to give each member a written notice of the specific dollar amount within 8 1/2 months from the end of the co-op's tax year in order to claim a patronage dividend exclusion against its patronage-sourced margins. Acceptable notification methods include:

- U.S. mail,
- Message on bill, and
- Message associated with electronic bill payment.

The method chosen should take into account the privacy issues associated with communicating financial information.

If a co-op has multiple allocations, for example, capital credits from its own operations and a separate allocation from an affiliated organization, it has the option of providing a combined allocation notice with separate line items for separate allocations or issuing a separate notice for each allocation. A more general notification method, such as including the allocation formula on bills, may be insufficient to allow a taxable co-op to claim a patronage dividend exclusion.

### Survey Results

Seventy-seven percent of respondents to the task force survey say they notify patrons annually of the dollar amount of their capital credits allocations.

Source: *Survey Report*, Capital Credits Task Force. March 9, 2004

[26] More information about these services is available through the Postal Service Web site, **www.usps.com**

### Keyword

**vest** To confer ownership of property upon a person, to invest a person with full title to property or to give a person an immediate, fixed right of present or future enjoyment.

There are strong arguments in favor of exempt co-ops notifying members of their patronage capital allocations, particularly systems that are close to failing the 85-percent test. If an IRS audit later finds the co-op to be taxable for a particular year and the co-op has failed to provide the proper notification, then the co-op will not be able to exclude capital credits from margins in computing its tax liability. Regardless of the co-op's situation with regard to the 85-percent test, notification provides an excellent opportunity to communicate with members regarding cooperative values while providing a tangible demonstration of the value of cooperative membership. Not sharing information with members about the degree of their economic participation is missing an opportunity.

## WHEN DOES A MEMBER'S RIGHT TO CAPITAL CREDITS VEST?

A key legal issue associated with capital credits is the determination of when a member's rights to the payment of capital credits vests—upon allocation or retirement. Whatever other provisions they contain, the bylaws of most electric cooperatives say that the co-op can only retire capital credits if the board of directors determines that the retirement will not impair or adversely affect the cooperative's financial position. Because of this required board determination, the majority of court cases addressing this issue have held that a cooperative member's right to the payment of capital credits vests upon retirement, not allocation. Thus the member has no vested right until the board takes formal action to retire capital credits.

This is an important distinction because it affects the rights and obligations of both the co-op and the member under federal tax law, federal bankruptcy law and RUS regulations, as well as state contract, property and corporate law.[27]

[27] For more information about legal issues related to vesting, please see Section D. Vesting of Capital Credits in *Legal Issues Associated with Capital Credits*, available online at **Cooperative.com**.

# Chapter 3: Retiring Capital Credits

### Questions for board consideration

- Why should a cooperative retire capital credits?
- What amount of capital credits should the co-op retire?
- How do co-ops fund capital credits retirements?
- What method of retiring capital credits best meets the co-op's strategic goals?
- Should the board authorize special retirements?
- Should the co-op apply discounts to early retirements?
- How might a security interest in capital credits affect the co-op?
- How might the bankruptcy of a member affect the co-op?
- What other retirement issues should the board address?
- Can the co-op use unclaimed capital credits to add value for members?

While the legal requirements for allocating capital credits are quite specific, the requirements for retirements are more flexible. Questions such as when to retire, how much to retire and what method to use can be complex and difficult to answer. The answers are affected by the co-op's financial and competitive situation, the demographics of its membership and its goals for capital credits.

## WHY SHOULD A COOPERATIVE RETIRE CAPITAL CREDITS?

There are both good business and legal reasons for retiring capital credits. The third cooperative principle establishes that members contribute capital equitably to the operation of the cooperative. The funds invested in the cooperative do not earn dividends or other financial remuneration. Retiring capital credits is a way of ensuring that each generation of members pays its own way by providing its own equity.

Retiring capital credits provides tangible evidence of members' ownership in the cooperative. It provides a unique opportunity to demonstrate the difference between cooperatives and other forms of business organization. It also helps solidify member loyalty by demonstrating the value of membership in the cooperative. Failure to retire capital credits can have a negative impact on public relations and even lead to litigation or a hostile takeover if unhappy members try to recover their investment in the cooperative.

There also are legal reasons to retire capital credits in order to preserve a cooperative's status under the tax laws, but it is necessary for the board, along with its advisers, to interpret the criteria. The IRS does not specifically define the conditions and circumstances that trigger the actual retirement, and the IRS and the courts give the board considerable discretion in determining when to retire capital credits.

### Keyword

**reserves** Funds set aside to meet expected or unexpected future needs, such as plant expansion or storm recovery.

IRS Revenue Ruling 72-36 allows a co-op to establish and maintain "reasonable reserves" for any legitimate business purpose, such as plant expansion, repayment of debt, storm recovery or the purchase of new businesses.[28] The IRS requires all co-ops to keep records of the rights and interests of members in reserve accounts but does not require tax-exempt co-ops to notify members of their interest in reserves. If the reserve is no longer needed, the funds in the account may be reassigned to capital credits.

The ruling prohibits the unreasonable accumulation of capital beyond the reasonable needs of the organization's business, but it says that whether there is an improper accumulation of funds depends on individual circumstances. There has been no test case on this issue, and there is very little legal guidance to define reasonable reserves. Thus, depending on the board's tolerance for risk, some co-ops maintain relatively low reserve levels while others maintain high reserve levels, even when it means that they do not retire capital credits. In practice, a board may be able to delay patronage capital retirements based upon a decision that capital is needed to meet specific business purposes.

The IRS has rarely challenged the business judgment of boards that fail to authorize capital credits retirements. At some point, however, capital accumulation may exceed any legitimate business need. If challenged by the IRS, this has the potential for serious consequences, such as the loss of cooperative status under federal tax law and member relations problems, which could lead to lawsuits to claim member capital or even action by members to sell the system in order to recoup their investments in the cooperative.

Under state law, if an electric cooperative allocates capital credits, then it probably has a legal obligation to retire these capital credits at a later date. The cooperative's board of directors, however, has considerable discretion in deciding when and how to retire capital credits, in accordance with any bylaw, policy or other requirements. If the board retires capital credits in an unreasonable, improper or arbitrary manner or if it fails to retire capital credits without a reasonable, proper and non-arbitrary reason, then the directors may be liable for abuse of discretion. There appears to be little statutory or case law specifying the parameters for abuse of discretion liability regarding capital credits retirements. Existing case law holds that, when addressing rates, capital credits and similar issues, directors of electric cooperatives are protected by the business judgment rule. In addition, courts have been hesitant to interfere with cooperative decisions regarding the retirement of capital credits.[29]

Nevertheless, directors have an obligation to make responsible decisions. It is important that each board member understand the board's retirement policies and decisions, including whether, how much and how to retire capital credits. As the members' representative, each director must be able to explain the issues and decisions to members who have questions.

## WHAT AMOUNT OF CAPITAL CREDITS SHOULD THE CO-OP RETIRE?

It is the board's responsibility to determine whether the co-op is in a financial position to retire capital credits and, if so, the dollar amount to retire in a given year. That decision is influenced by a number of factors, including:

- The co-op's financial performance,
- Its equity management plan,
- Rate competitiveness, and
- Regulatory bodies.

Other considerations include lender requirements[30] and the views of the financial markets,[31] both of which influence the cooperative's ability to obtain funds in the future. The board may choose to retire a percentage of the previous year's margins, capital credits allocated for specific years or a specific dollar amount.

[28] The complete text of Revenue Ruling 72-36, 1972-1 C.B. 151 is shown on page 58.
[29] For more information, please see Section B-4, Obligation to Retire in *Legal Issues Associated with Capital Credits*, available online at **Cooperative.com**.
[30] See page 61.
[31] See page 62 and *Comments of Fitch Ratings* available online at **Cooperative.com**

### Financial Performance

The board should consider the impact of any proposed capital credits retirement on the cooperative's liquidity, equity level and rates along with its ability to comply with loan agreements and mortgage covenants. A sound equity management plan can help the board evaluate this issue.

### Equity Management Plan

It is good business practice to generate adequate capital to fund operating costs, reserves and some pre-determined portion of plant growth and renewal, but a cooperative should not retain capital above a level that is reasonable and justifiable. A sound equity management plan can help a co-op meet this test by balancing the need to maintain adequate levels of equity, obtain debt at a reasonable cost and retire capital credits in a timely manner. The plan should reflect individual factors affecting financial requirements, including:

- The cost and availability of capital,
- Loan and mortgage requirements of lenders,
- Capital requirements for utility plant, and
- The co-op's competitive position.

The equity management plan should take into account the need to ensure fairness across the generations of members served by the co-op.

An equity management plan helps a co-op manage debt, equity, rates and capital credits, given the system's rate of growth, and existing and proposed capital structure. The plan should not be a static document. Good business planning requires that the plan be reviewed and updated annually to reflect changing circumstances, such as fluctuations in the cost of debt and equity capital, changes in the rate of growth, competition and other variables.

The first step in developing the plan should be to determine the cost of capital. The cost of debt depends on a number of factors, including the capital markets, the cooperative's own financial strength and changes in government lending programs. The cost of debt is generally less than the cost of equity. Since a cooperative is not allowed to pay a return on equity contributed by its members, some people say that the cost of equity to a cooperative is zero, but that is incorrect. The Goodwin formula[32] offers a more realistic view. It calculates the rate of return on equity a co-op must earn to maintain equity at a given level while meeting growth needs and retiring capital credits. It shows that there is a cost to equity even for a co-op experiencing very low growth.

**Recommendation**
Management Equity Plan

Every electric cooperative should develop and implement an equity management plan that supports its capital credits policy based on the co-op's equity and debt requirements, financial performance and competitive situation. The equity management plan should include rates that will generate adequate cash to provide capital credits retirements.

**Keyword**

**equity management** The phrase the cooperative network has historically used to refer to capital structure planning and decision making.

[32] Additional information about the Goodwin formula can be found in Appendix 6.

### Survey Result

Sixty percent of respondents to the task force survey say their capital credits retirement program is based on a formal equity management or financial plan.

Source: *Survey Report*, Capital Credits Task Force, March 9, 2004

It is also important to consider the viewpoint of the member, who loses the opportunity to use the funds retained by the cooperative for other purposes, such as investments or retiring personal debt. While each member is different, the cost of its equity investment in the co-op is probably at least as high as the return the member could expect to earn on a similar investment, such as a 10-year Treasury bond, and may be as high as a credit card rate.[33]

In considering the cost to members, it is important to consider the cost of equity in reserves as well as the cost of equity allocated as capital credits. Like margins, money to fund reserve accounts comes from contributions from members, which carry a cost to the member.

Some cooperatives have reached the conclusion that it is in the members' best interest to finance the co-op entirely through equity, while others would use 100 percent debt financing if possible. The best approach avoids either extreme. Higher equity provides flexibility and a cushion against hard times, such as a natural or financial disaster, but may make a takeover more attractive to members. If a co-op maintains a very high level of equity and fails to return capital credits, it may also raise a question as to whether the co-op is operating on a cooperative basis. Lower equity raises concerns for lenders and may affect the co-op's ability to obtain new debt capital, a particularly important concern for co-ops experiencing faster rates of growth. Higher equity may result in a lower interest cost on debt, although this is less of an issue with program lenders. The cost of debt is still likely to be less than the opportunity cost for the member's equity, so lower equity is likely to result in a lower overall cost to the member.

A carefully considered equity management plan can help a system balance these competing interests to determine its optimum equity level. Maintaining equity in the optimum range provides the lowest cost of capital, ensures that the co-op has access to adequate capital and allows for return of capital credits on a reasonable basis. The Boatman Theorem, developed by Jim Boatman, who served as an area representative and director of Planning and Program Analysis for CFC, offers one method for determining the amount of equity that should be retired as capital credits each year. It says that the percentage amount of equity that should be returned each year is equal to the difference between the co-op's rate of return on equity (which can be determined from the Goodwin model) and the co-op's growth in capital.[34]

### Rate Competitiveness

Rate considerations are an important part of a co-op's equity management plan. Most co-ops do not have to choose between having competitive rates and retiring capital credits. Developing an equity management plan that includes rates sufficient to provide for capital credits retirements is an essential part of the planning process.

[33] See page 49.
[34] Additional information about the Goodwin formula can be found in Appendix 6.

The cash members receive from capital credits retirements may effectively offset part of costs paid through rates. Depending on the retirement method adopted, this can have an immediate impact.

### Regulatory Requirements

Cooperatives that are subject to state regulation of rates or other activities must comply with any regulatory rulings affecting capital credits retirements.[35]

## HOW DO CO-OPS FUND CAPITAL CREDITS RETIREMENTS?

Even co-ops that are strongly committed to retiring capital credits sometimes express concern about having adequate cash to fund capital credits retirements and meet other needs. While margins and depreciation on plant investment are sources of funds for patronage capital retirements, there are competing uses for the cash, such as plant additions and principal payments on existing debt.

Some cooperatives have expressed a concern that they may have to adopt higher rates or borrow funds to repay capital credits. As a practical matter, planning for availability and use of cash involves a process that considers funding capital additions, amortization of existing debt, capital credits retirements, rates and rate parity, and equity levels. Cooperatives should develop equity management plans that take into consideration the many uses of funds and the need to build and/or maintain financial strength for future ratepayers. Cooperatives pay for capital additions with general funds, and often requisition debt after construction is completed. Good cash management demands that funds be borrowed only when they can be put to use, as the co-op is unlikely to be able to earn a return on invested funds that is higher than the cost of borrowing. It is an acceptable practice to borrow, if necessary, in order to have the actual cash to retire patronage capital. If the cooperative is following its equity management plan, it should be indifferent to the actual source of cash at the time of retirement. Ultimately, all costs to the cooperative are funded out of rates, either directly or through payments of principal and interest.

**Recommendation**
Adequate Equity Level

Each electric cooperative should seek to maintain an equity level adequate to retire capital credits on an annual basis and meet the goals and requirements of its equity management plan. The task force suggests that a reasonable equity level for most distribution systems is in the range of 30 to 50 percent, depending on the cooperative's financial and competitive situation.



[35] See page 61.