Learn from Experience
Butler REC Strikes a Healthy Balance

At Butler Rural Electric Cooperative in Oxford, Ohio, capital credits are an integral part of the strategic planning process and play a significant role in ensuring that its members are protected as much as possible from volatile rates.

"Like other co-ops, we believe our more than 10,000 members are our highest priority," General Manager Michael Sims said. Butler continually strives to be responsive to its local communities and to improve the lives of its members. "For many years, our board has viewed our capital credits policy as not only a way to show our members how we are different from other utilities but also as a tool for enabling us to offer them competitive and stable rates."

Butler uses a percentage/FIFO hybrid for returning capital credits. "We return 100 percent of capital credits accrued 15 years prior and a percentage of the previous year's patronage," Sims said. "Last year we had an exceptional year. A very cold winter and a very warm summer caused our kwh sales and margins to soar. While we normally might return about 15 percent of current-year margins, last year our board decided to return 35 percent. Our members appreciate that we keep rates stable but that they also see a special reward through capital credits when we have an exceptional year."

Communication becomes very important for Butler so members understand the role of capital credits. Using its 10-year financial forecast, which is an important part of its equity management plan, Butler plans for the long-term with an emphasis on minimizing rate fluctuations. "Balance is very important. Our capital credits approach is designed to provide a cushion of rate protection for our members. When things are good, they benefit. Other years, the payout is more modest," Sims said. "For three years now, we have done an annual customer attitude survey. Our survey tells us that our members seem to recognize and understand the value of this approach." Butler strives to keep communications with its members very straightforward and not technical. In addition to its member newsletter and bill statements and stuffers, Butler boasts a dynamic Web site, including an informative, easy-to-read FAQ section on capital credits.

"When we're able to explain why we're different, members embrace our cooperative roots," Sims said. Predictable rates, reliable electric service, and strong ties with community do tell the cooperative story, and will keep the story alive and well far into the future.

WHAT METHOD OF RETIRING CAPITAL CREDITS BEST MEETS THE CO-OP'S STRATEGIC GOALS?

In addition to determining what level of capital credits to retire, the board must also determine how to retire capital credits.

Lenders earn a return on their investments in loans through interest payments. Investors in stock companies earn a return on their investments through dividends and capital appreciation. Members do not earn a return on their investment (through margins) in a cooperative. Instead they receive the benefits of electric service provided at a cost that does not include profits, and their investment, or margins paid, is ultimately returned through capital credits retirements.

Unless the bylaws or other authority specify retirement procedures, it is up to the board to decide 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?[36]
- **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?

The board also must consider the desirability of special retirements, such as those to estates, in addition to general retirements to all members and whether to discount capital credits, either voluntarily or involuntarily, for general and/or special retirements.

Each method for retiring capital credits has advantages and disadvantages, and the one chosen should be the one that best meets the objectives of the individual cooperative. Common retirement methods for general retirements include:

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

In adopting any new capital credits retirement plan, the board should be sure to consider potential legal and accounting issues, including what is fair to longer-term members. If an electric cooperative's bylaws require it to retire capital credits according to a specific method, then there are unique legal issues to consider if a bylaw amendment is necessary. For example, if an electric cooperative amends its bylaws to revise the method for retiring capital credits, then members not voting for the amendment could argue that their conditional contract right to capital credits retirements under the previous method is sufficiently substantial that they are not bound by the bylaw amendment. If, however, they accept capital credits retirements under the bylaw amendment, then they may be prevented from challenging the amendment. The legal issues involving amending capital credits retirement bylaws are complex and often unclear. For additional information, see "Legal Issues Associated with Capital Credits Retirements," which can be found on Cooperative.com.

Recommendation

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.

[36] About 14.2 percent of U.S. residents moved in 2003. For more information, see page 65

Survey Results

Eighty-three percent of respondents to the task force survey said that the co-op's bylaws allow the board to select the capital credits retirement method while 17 percent said that the bylaws require a specific method. Respondents reported using the following retirement methods:

Method	Percent Using
FIFO	43%
LIFO/FIFO Hybrid	21%
Percentage/FIFO Hybrid	15%
Other	21%

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

FIFO

The FIFO method retires capital credits in the order in which they were allocated. It is the method most commonly used historically and today, and it is one of the easiest to administer. It can be defended from the standpoint that each generation of members pays its own way. FIFO's goal is to keep every member's money for the same period of time. It is most favorable to long-term members, whether they are still receiving service or not. Those who have provided capital to the cooperative for a longer time without receipt of interest or dividends, obtain a return of that capital before other members who made capital available to the cooperative for a shorter period of time. Systems with low growth and member turnover may continue to benefit from the FIFO retirement method, because most members will receive services and remain active, loyal members for a long time.

However, FIFO may no longer be the best method for other cooperatives. There is a significant delay between the time when the member receives a capital credits allocation and receives the first retirement. It is not favorable to newer members, who may use larger amounts of electricity than members did years ago and therefore contribute more to overall equity.

FIFO does little to build loyalty among newer members or to educate those members about the benefits of cooperative ownership.

Percentage of Total Allocated Capital Credits

The percentage method retires a percentage of each member's total capital credits account, regardless of when the capital credits were allocated. For example, if the co-op decides to retire 5 percent of its capital credits, each member would receive payment for 5 percent of its total capital credits contributions. An advantage of this approach is that both longer-term and newer members share in the distribution of capital, providing an educational and member loyalty opportunity for all members. Another advantage is that it provides the biggest refund to those who have contributed the most capital to the organization (the higher amount in the capital credits account, the greater the dollar amount of the retirement). The percentage method emphasizes a member's total participation in the co-op over time rather than that of a single year.

However, some members may raise the question as to why some recent allocations are retired ahead of older allocations. There also may be additional administrative requirements to maintain records, as it may take longer to completely retire the oldest allocations.

In the case of inactive members, if a percentage of each capital credits account is returned each year, the total amount of the account will get smaller and smaller but will never reach zero. The board should establish a minimum level for former members' accounts at which the entire balance will be refunded.

Learn from Experience
Wood County EC Takes Pride in Giving Back to Community

Situated in beautiful northeast Texas about 90 minutes east of Dallas, Wood County Electric Cooperative takes pride in giving back to its community. Wood County's directors and employees serve on local school and industrial boards, participate in chambers of commerce and show up regularly at 4-H club meetings, livestock shows and other local events. "We're driven by a unique spirit of cooperation and independence," General Manager Debbie Robinson said. "We seek to provide the most reliable, cost-effective electric power possible to our members, and we strive daily to fulfill the dreams of our founders."

But the giving back to community doesn't stop here. Since the mid 1970s, Wood County has been retiring capital credits to its 22,000 members based on the percentage method. "Based historically on an RUS guideline, we generally retire 25 percent of prior year's margins," Chief Financial Officer Trey Teaff said. "However, this is an annual decision, and our board uses our 10-year financial forecast along with our equity management policy as a tool for determining the dollar amount of our retirement. To calculate an individual member's payout, we take the total retirement dollars and divide them by the total allocated balance for all current and former members. This gives us our factor—or percentage. This factor is then multiplied by the capital credits balance in each member's account to determine the check amount."

Using the percentage method, nearly 70 percent of Wood County's current members received a check this year. "It generally only takes a few years for a new member to have a capital credits account balance big enough to pay out," Teaff said. "There is great value to reaching this many members...particularly when it comes in the form of a check just before the holidays. Very few people are excluded, and the longer you've been receiving electric power from us the more you benefit."

While Wood County is a mostly rural system, the co-op experiences steady growth each year. This Texas co-op's capital credits approach reaches out to newer members effectively but it also recognizes, rewards and, in Texas style, "tips its hat" to long-time supporters.

LIFO

The LIFO method retires capital credits in the reverse order in which they were allocated. It provides an efficient way to get money back into the hands of current members almost immediately. It can help a cooperative with a fast-growing or transient membership build loyalty because it demonstrates the benefits of the cooperative business model immediately. It also minimizes the difficulty of locating former members to make retirements.

One drawback, however, is that members who have had capital invested in the cooperative for the longest period of time are the last to be paid back, and some longer-term capital credits investments may never be repaid. This has the potential of creating public relations or other difficulties if the older or former members perceive they are being penalized and challenge the board's action. For these reasons, LIFO is generally not used alone but rather is adopted as part of a hybrid approach.

Hybrid Methods—General

Hybrid methods combining two or more approaches are becoming increasingly popular because they allow the co-op to honor the contribution of longer-term members while also recognizing the contribution of other, newer members.

The greatest benefit of the hybrid approach is that the advantages of one retirement method chosen can partially offset the disadvantages of the other. A hybrid plan, however, may require more staff resources because it may be more difficult to explain to members and to administer.

LIFO/FIFO Hybrid

The LIFO/FIFO hybrid is currently the major alternative to the FIFO technique. It recognizes the contributions of longer-term members while providing retirements to most current members.

It may, however, require more staff resources and may also exclude former members with capital credits that are neither first nor last in but rather between those extremes.

Percentage/FIFO Hybrid

The percentage/FIFO hybrid is the third most commonly used technique. It provides a way to continue to recognize the contribution of longer-term members while providing a refund to most members. It also can be a useful tool for transitioning from FIFO to the percentage approach. This method also emphasizes a member's total participation in the co-op over time rather than that of a single year.

It may, however, require more staff resources, and some members may raise the question as to why some recent allocations are retired ahead of older allocations.

SHOULD THE BOARD AUTHORIZE SPECIAL RETIREMENTS?

The board may decide as part of its policy to authorize special retirements of capital credits to recognize special circumstances. Retiring capital credits to the estates of deceased members is a widespread practice with 73 percent of the co-ops responding to the task force survey reporting estate retirements. In recent years, some co-ops have implemented, or considered implementing, other special retirements, including:

- Members who have attained a certain age,
- Inactive members,
- Overdue accounts, and
- Early general retirements.

Since the 1976 capital credits study, there has been a trend toward discounting early retirements.[37]

The board must decide whether the advantages of a particular special retirement outweigh any possible disadvantages. One question to consider is whether special retirements unlawfully discriminate against some members in favor of others. From a cooperative law standpoint, unless a governing legal authority, such as state law, federal law or the co-op's bylaws, says otherwise, the cooperative can probably make special retirements as long as the retirements are reasonable and fair and as long as all similarly situated members are treated the same. Whether a particular special retirement is determined to be reasonable and fair depends on the specific facts and circumstances of the individual cooperative and retirement. Every cooperative should consult its legal and tax advisers regarding its current and proposed special retirements.[38]

Estates

Although discretionary on the co-op's part, the most common special retirement is to estates. From the members' perspective, estate retirements help the family of the deceased member meet funeral costs and other expenses and allow the estate administrator to achieve a timely settlement of the estate. The major benefit to the co-op is that it closes out the member's records. It can be difficult and sometimes impossible to locate the heirs of an estate 20 years after the death of a member. This can result in unclaimed capital credits being paid to the state under the Uniform Disposition of Unclaimed Property Act or a possible escheat situation. If a co-op retires capital credits to the estates of deceased individual members, there is a legal issue regarding whether it must retire capital credits to dissolving or liquidating corporate members.

[37] See page 47.
[38] For more information, please see Section E, Special Capital Credit Retirements in *Legal Issues Associated with Capital Credits*, available online at Cooperative.com

Learn from Experience
Linn County REC Says It's Not Magic...It's Just Good Business!

While Linn County Rural Electric Cooperative, Marion, Iowa, is quick to say that there's nothing magical about what they're doing with capital credits, this mid-sized cooperative is getting the attention of its growing membership in simple ways through consistency, flexibility and communication.

When asked how long they've been retiring capital credits, Linn County CEO Kim Colberg jokingly responds, "Well...since the beginning of time, of course!" That's a slight exaggeration, but the cooperative has made it a high priority to consistently return capital credits to members since its incorporation, with few exceptions. "Up until the late 1990s we had always used the traditional FIFO method but, as part of our long-term planning process, our board felt we really needed to rethink our approach," Colberg said.

The co-op learned from a study done by its power supplier that a very large percentage of its membership has been on line for less than five years. The traditional capital credits policy was "doing the job," but there was clearly a missed opportunity for enhancing Linn County's relationship with its growing number of newer members. "As you'll hear from other cooperatives, getting the attention of these newer members is never easy," Colberg said. "Our decision to change to a hybrid method—we now return a percentage of our current year's allocation along with earlier allocations—has gotten our members' attention and it has made a difference."

The co-op aggressively communicates the value of capital credits and promotes all of its capital credits activities in its newsletters, on its Web site, and in its bill statements. Linn County's members receive their capital credits in the form of a credit on their bill. "We've saved money with this approach but, more importantly, we've received positive feedback from our members that they prefer the credit. It just becomes very important to show the credit as a separate line item so it doesn't go unnoticed. Additionally, we show the credit in a note box at the top of each bill," Colberg said. "We have also found that many commercial members prefer to see the credit on their bill. Oftentimes, when a check is mailed, it's goes to corporate headquarters and gets lost in the shuffle. From the co-op's perspective, it's nice to showcase the savings in a visible way that is reflected on their bill."

Linn County's situation isn't unique but it does serve as a reminder that as cooperative communities and memberships evolve, so must cooperative policies. "Our board wanted the utmost flexibility to use capital credits as another way of reaching and educating our newer members while still effectively and fairly serving our long-time members," Colberg said. Linn County's policy reflects its desire to balance these needs with the important task of ensuring the co-op's financial health today and far into the future.

Age-related Retirements

Retiring capital credits to members who reach a certain age, 65 for example, benefits the member directly instead of the estate and rewards older members for their loyalty to the cooperative. It may, however, be discriminatory against other members unless a discount is applied, or it may become a financial burden to other members as the membership ages.

If the co-op does not receive federal financial assistance, there does not appear to be a general prohibition against this type of discrimination. However, if the co-op receives federal financial assistance from RUS or otherwise, then age-related special retirements may violate the Age Discrimination Act of 1975 (ADA) as well as RUS and other regulations.[39] In addition, depending on the outcome of current deliberations, SFAS No. 150 may require a cooperative to classify as a liability capital credits that will be retired when a member reaches a specific age.

[39] For more information, please see Section E 3, Age in *Legal Issues Associated with Capital Credits*, available online at **Cooperative.com**.

Recommendation
Age of Members

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

Inactive Members

As with retirements to estates, retiring capital credits to inactive members, such as those moving out of the service territory, simplifies record-keeping and eliminates potential escheat situations. A possible problem, however, is that a member could change the name of the service from one member of the household to another in order to get the refund. The board may wish to apply conditions to this type of special retirement, such as a period of time that the account must be inactive. This approach also may improperly discriminate against active members unless an appropriate discount is applied to the refund.

Bad Debts

Under the bylaws of most electric cooperatives, unpaid debts to the cooperative are offset against retired capital credits. Under a policy of general application, some cooperatives use special retirements to reduce bad debts by retiring capital credits and applying the amount to inactive accounts of members who leave the cooperative owing money. Co-ops also can apply a discount to the retirement[40] and impose a processing fee to reflect the actual cost to the co-op and reduce any incentive for current members to withhold bill payments in order to collect capital credits. This type of special retirement should not be used for active accounts.

While this approach does not actually generate additional cash income, it may help the co-op reduce its bad debts and simplify its books. Keep in mind that if the former member is involved in a bankruptcy proceeding or files for bankruptcy within 90 days after the offset, there may be restrictions on the cooperative's ability to do this.[41]

Other Issues

The IRS permits both voluntary and involuntary special retirements. For example, the co-op may give an estate the choice of voluntarily accepting a discounted retirement now or a full value retirement at the scheduled retirement date. The board could decide to make involuntary retirements to overdue accounts or those leaving the system. Some people say that involuntary retirements are contrary to cooperative principles and that the member should always consent to an early retirement. In addition, state law may prohibit or limit involuntary discounting of capital credits.

Questions to answer in considering any special retirement include:

- Is the retirement fair and reasonable to both the members receiving the retirement and to the other members of the cooperative?
- Are all similarly situated members treated the same?
- Will it pose an undue burden on future or current members?

As with other aspects of capital credits retirements, there is not necessarily a right or wrong approach to special retirements. What is important is for the board to understand the consequences of the decision it makes.

[40] See page 47.
[41] For more information, please see Section F, Security Interest in Capital Credits in *Legal Issues Associated with Capital Credits*, available online at Cooperative.com.

Each Capital Credits Retirement Method Offers Advantages and Disadvantages

Method	Percent Using*	Definition	Advantages	Disadvantages
FIFO First-in, First-out	43	Retires in order allocated	Helps each generation pay its own way; Rewards loyalty of long-term members for use of capital without interest or dividends	Creates significant delay between allocation and retirement; Does not reward newer members, who may use more services and contribute more to overall equity
FIFO/ Percentage Hybrid	15	Combines FIFO and Percentage of Total Allocated Capital Credits approaches	Recognizes use of longer-term members' capital while providing retirements to all members	May have additional administrative requirements; May be less favorable to longer-term members
LIFO Last-in, First-out	1	Retires in reverse of order allocated	Demonstrates benefits of co-op membership by rewarding most members immediately; Reduces difficulty of making retirements to former members	May raise question of fairness as more recent allocations retired ahead of older allocations; Older allocations will never be retired
LIFO/FIFO Hybrid	21	Combines FIFO and LIFO approaches	Recognizes contribution of longer-term members while providing retirements to current members	May have additional administrative requirements; May be less favorable to longer-term members and former members with capital credits between extremes
Percentage of Total Allocated Capital Credits	N/A	Retires percentage of each member's capital credits account each year	Lets older and new members share in return of capital; Provides largest refund to those who have contributed most capital	May raise question of fairness; May have additional administrative requirements
Special Retirements	N/A	Recognizes special circumstances through retire-ments, such as retirements to estates; may be discounted to ensure fairness	Addresses specific needs for each group; May create permanent equity	May treat members differently; May create taxable income

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

Recommendation
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.

SHOULD THE CO-OP APPLY DISCOUNTS TO EARLY CAPITAL CREDITS RETIREMENTS?

Most cooperatives make both special and general capital credits retirements. A special retirement allows the cooperative to make a payment sooner than it otherwise would. There can be good reasons for doing that, especially in the case of accounts that are no longer active due to a death or a member leaving the system. There is, however, 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. Some cooperatives discount, or reduce the amount of, special retirements to reflect the time value of money. Discounting provides a fair way to recognize special circumstances while continuing to treat members equally.

A few cooperatives also offer early general retirements at a discount. The primary reason cited for this is a desire to create permanent equity.[42] The decision to make general retirements out of cycle is, however, different from the decision to offer special retirements. A discounted special retirement offers a fair way to treat atypical circumstances. Discounting general retirements does not have the same leveling effect among the membership because in a general retirement, all members receive the same nominal dollars. It is difficult to administer such a practice fairly while maintaining a strong financial performance, and it may put the cooperative at risk for failing the 85-percent test.

The IRS has issued a number of private-letter rulings concerning discounting capital credits refunds, but the treatment of discounts is an issue that is still evolving. Any discount plan should take into consideration the potential to create non-member income affecting the co-op's tax status under the 85-percent member income test in IRC Section 501(c)(12).

In order to preserve its position in potential litigation with respect to Subchapter T cooperatives, the IRS has taken the conservative position that any amount retained by a Section 501(c)(12) cooperative after a discounted capital credits retirement is non-member income.[43]

Three private-letter rulings in 2003 found that a discounting plan does not adversely affect cooperative status nor does it jeopardize the ability to exclude allocated capital credits from income. These rulings also found that a discounting plan creates non-member taxable income under the 85-percent test since the amount is not maintained in the name of the member. Other IRS rulings issued in 2003 to exempt electric co-ops, however, held that no income would be recognized if the amount of the capital credits retained by the cooperative as part of the discounting process was held in the participant's name and redeemable only upon liquidation.

Keyword

discount To calculate the present value of an amount that would otherwise be received in the future to reflect the time value of money.

[42] See page 19
[43] The IRS took the position in a case involving Gold Kist, Inc., a Subchapter T cooperative that the amount remaining after a discounted capital credits refund resulted in non-patronage income because the co-op had received a tax benefit in the form of a deduction of the entire amount. The 11th Circuit Court of appeals in Atlanta ultimately ruled that no income resulted from the discounting. This ruling only applies to Sub T cooperatives in states under the jurisdiction of the 11th Circuit and does not apply to exempt or nonexempt rural electric cooperatives. The IRS is expected to litigate this issue in another jurisdiction.

Other discounting issues that have not been resolved by the IRS include:

- The level of board discretion,
- Whether discounting requires member consent, and
- Whether discounting can be applied to a limited group of members.

The impact of state laws on discounts also is uncertain. Historically, cooperatives have looked primarily to federal tax rules and regulations for guidance on capital credits; however, courts, electric cooperative members and others are increasingly examining the impact of state electric cooperative statutes on capital credits issues.

The Discount Rate

If a cooperative elects to discount some 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. The board should be able to justify and verify the rate chosen.

There are various options for the discount rate. Some people argue that equity is free; thus, the discount rate should be zero. Other people argue that the discount rate should be equal to the co-op's cost of equity, because the co-op is giving up equity. There is a cost associated with capital credits returned to members, because it must be replaced, either with debt or more equity.

There is no one standard that is appropriate for every cooperative in every situation. The co-op can evaluate the cost from the perspective of the cooperative, the member or an outside benchmark. The measure chosen should be easy to calculate, easy to explain and defensible. It should be fair to members both individually and collectively. The co-op's weighted cost of capital, which reflects the cost of both debt and equity, meets these criteria.

Since rates change often, the rate chosen should be reviewed and adjusted periodically to ensure that it continues to be fair.

Recommendation

Recommended Discount Rate

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

Survey Results

Seventeen percent of respondents to the task force survey said they discounted general capital credits retirements. Sixty-four percent of survey respondents discount capital credits retirements to estates.

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

A Co-op's Weighted Cost of Capital Is an Appropriate Benchmark for Discount Rate

The co-op's weighted cost of capital reflects the cost of both debt and equity. It provides a reasonable standard for the discount rate for discounting capital credits retirements. This example assumes a co-op has:

- 40 percent equity,
- 60 percent debt and
- A cost of capital equal to the median for distribution co-ops in 2003, including an average weighted cost of debt of 5.0 percent and an average cost of equity of 9 percent.

Co-op's Weighted Cost of Capital =
[Average Weighted Cost of Debt X Percent Debt] + [Cost of Equity X Percent Equity]

Element of Capital		Co-op's Cost		Percent of Capitalization		Contribution to Cost of Capital
Debt		5.0 %	X	60	=	3.0%
Equity	+	9.0 %	X	40	=	3.6%
Weighted Cost of Capital/Suggested Discount Rate						6.6%

A Capital Credits Discount Rate Should Be Justifiable and Verifiable

Rate	Amount (percent)*
Co-op's average cost of debt	5.0
Co-op's average cost of equity	9.0
Co-op's weighted cost of capital	6.6

Other Benchmarks	Source	Amount (percent)*
Member's long-term mortgage rate	Federal Housing Finance Board	5.96
20-year bond, A-rated utility	Bankrate.com	6.0
Co-op's theoretical cost of equity	Goodwin formula (3 percent growth rate)	6.72–11.71
Investor-owned utility benchmark	Return on equity (after tax)	10–11
Member's alternative investment option	10-year Treasuries	4.2
Member's credit card rate	Bankrate.com	12.7 (fixed) 13.8 (short-term variable)

*As of September 2004

The Discount Rate Should Be Fair to Both Co-op and Member

The following example shows the capital credits retirement due a member that has been allocated $50 each year for 20 years for a total of $1,000 after the retirement has been discounted at various rates.

Discount Rate (Percent)	Discounted Capital Credits Refund to Member	Amount Retained by Cooperative
4	$680	$320
6	$574	$426
8	$490	$509
10	$426	$574
12	$373	$627

Member Consent

If a cooperative may legally discount capital credits retirements without member consent, then a board should still consider making discounted retirements subject to member agreement. For example, a member leaving the service territory would have the option of accepting a capital credits retirement at a discount or leaving the investment with the cooperative until the normally occurring retirement date. If the policy is structured correctly, both the member and the co-op should be indifferent financially to the decision, although some members may have a preference for receiving the retirement sooner rather than later.

HOW MIGHT A SECURITY INTEREST IN CAPITAL CREDITS AFFECT THE CO-OP?

To secure a member's obligation to pay an electric cooperative, the co-op may desire to create and perfect a security interest in the member's capital credits. This security interest may protect the co-op against other creditors of the member, like banks, who knowingly or unknowingly have a security interest in the member's capital credits. It also may provide certain preferences and priorities if the member files for bankruptcy, and it may allow the cooperative to offset discharged debts against the member's retired capital credits. Creating and perfecting a security interest in capital credits has practical and legal advantages and disadvantages. When addressing security interest issues, a co-op should consult its attorney.[44]

HOW MIGHT THE BANKRUPTCY OF A MEMBER AFFECT THE CO-OP?

When a member of an electric cooperative files for bankruptcy, it raises important issues regarding the member's capital credits. First of all, the co-op cannot discontinue service to a member because of the bankruptcy filing or because of debts owed to the cooperative at the time of the bankruptcy filing. The co-op can, however, require the member to provide adequate assurance that the member will pay for future electric service. A co-op could seek to use the member's capital credits as part of this assurance.

Second, the bankruptcy court or trustee may seek to force the cooperative to immediately retire and pay the member's capital credits into the bankruptcy estate. Existing case law, however, indicates that the court or trustee does not have this right. Third, the bankruptcy filing may affect the cooperative's ability to set off or recoup the member's debt to the cooperative (even when the debt is discharged) against the member's capital credits, whether retired now or in the future. Fourth, having a security interest in the member's capital credits may be an advantage, or a disadvantage. Fifth, the bankruptcy filing may impose a duty upon the cooperative to report the member's capital credits to the trustee or court. These issues are complex and confusing and an electric cooperative should consult its attorney.[45]

[44] For additional information, please see Section F, Security Interest in Capital Credits in *Legal Issues Associated with Capital Credits*, available online at **Cooperative.com**

[45] For additional information, please see Section G, Capital Credits in Bankruptcy in *Legal Issues Associated with Capital Credits*, available online at **Cooperative.com**

Learn from Experience
Farmers EC Gives Members a Fair and Reasonable Choice

When it comes to dealing with the capital credits account of a deceased member, Farmers Electric Cooperative in Clovis, New Mexico, wants to be sensitive to a member's family as well as a prudent steward of all its members' investments. As many cooperatives have experienced, finding this balance is never easy.

"Our board and staff have always pursued an aggressive capital credits policy, which includes a discount policy," Farmers EC General Manager Lance Adkins said. Farmers uses a formula developed by its accounting firm to calculate the percentage of capital credits it will return each year. The co-op generally retires a percentage of its capital credits from every year, ranging from 100 percent of its oldest year's margins to a fairly high percent of its current-year margins. In fact, for the last several years, Farmers has retired from 40 to 50 percent of its current-year margins.

"This policy has worked well for our co-op. We believe that it's important, especially for our newer members, to see that capital credits check each year. We can talk and write about member ownership all we want, but a check makes it real to them," Adkins said. The co-op also offers special capital credits retirements to estates at a discount. "The portion of our policy that allows for discounting is not our most popular program, but we feel strongly that it is reasonable, fair to members, and financially prudent for our co-op."

The kwh sales to Farmers' membership is divided fairly equally between residential, small and large commercial, and irrigators. "It wouldn't have much financial impact to retire capital credits early at 100 percent of their value to residential customers, but this wouldn't be the case with our other member classes," Adkins said. "An early retirement for these members could have a significant financial impact on our co-op. The goal of our policy is treat all our members equally and fairly."

Farmers offers the member's estate representative a choice between receiving the retirement on the normal schedule or receiving a payout of all capital credits at a discounted rate. The discount rate is calculated on sliding scale based on the year of the allocation. Finally, Farmers also offers these members the option to donate their capital credits—at 100 percent on their normal cycle—to an education foundation that funds scholarships for Farmers' members and, sometimes, their direct dependents.

"There's certainly not one answer for this issue. We strive to be fair and to minimize the financial exposure to our co-op long-term," Adkins said. Many co-ops will continue to wrestle with this issue and will need to stay abreast of both tax and legal issues to protect the co-op and its members' investments.

WHAT OTHER RETIREMENT ISSUES SHOULD THE BOARD ADDRESS?

Minimum Amount for Capital Credits Checks

Some cooperatives set a minimum retirement amount for capital credits checks, such as $5 to $10. If the capital credits payment due to an active member is less than the minimum, the retired amount is held until it can be combined with future capital credits retirements to reach the minimum check level. In the case of inactive accounts where there is no expectation of additional future capital credits allocations, the co-op may choose to retire the full amount, possibly at a discount, and clear the capital credits account. Some co-ops apply a reasonable service charge for maintaining records on inactive accounts that do not meet the minimum check amount.

Multiple Accounts

Some consumers have multiple billing accounts, such as an account for a residence and a business. These may be accumulated into one capital credits account. There may, however, be problems if some of the accounts fall into different classes of service covered by different capital credits policies. A co-op can avoid this issue by establishing a different capital credits account for each billing account.

SFAS 150

The current generally accepted accounting procedures for capital credits[46] require assigned capital credits with no fixed maturity date to be reported as equity.

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards #150 (SFAS 150) to address issues regarding classification of equity and liabilities. The reason for the proposed standard is to improve the transparency of financial instruments that have both equity and liability characteristics and to conform U.S. accounting procedures to international practice.

As originally proposed, SFAS 150 said that mandatorily redeemable financial instruments, including capital credits, payable at a date certain or when an event certain to occur does occur, should be considered a liability, not equity. In other words, if a co-op member could demand payment based on an event certain to happen, the member's capital credits account would be considered a mandatorily redeemable liability. Depending on the ultimate definition of a mandatorily redeemable obligation, the proposed standard had the potential to substantially reduce a cooperative's level of equity. The cooperative network was able to gain an indefinite delay in the implementation of this standard while the matter was under consideration.

NRECA, CFC and RUS filed joint comments with the FASB in October 2003, arguing that the Board discretion exercised in the redemption of capital credits upon the death of its members or under other circumstance is little different from the discretion that boards of for-profit companies exercise in distributing dividends to shareholders. If future dividend payments are not to be considered a liability under SFAS 150, then capital credits should not be considered a liability.

In October 2004, the FASB tentatively adopted a new-equity liability classification plan that would base the equity or liability classification of financial instruments issued by a business enterprise, including stock, capital credits and other items, on the degree to which the financial instrument reflects an "ownership relationship" in the business. Financial instruments that establish a "direct ownership relationship"—interests that are the most subordinated and that share in the business's risks and rewards, including capital credits—would always be considered equity. Financial instruments with an "indirect ownership relationship—interests indexed to and in the same direction as the most subordinated interest—would be considered equity only if their ultimate settlements, if any, would establish a direct ownership relationship. Otherwise, they would be considered liabilities. Financial instruments that establish neither a direct nor indirect ownership relationship will be considered liabilities if they require or may require settlement.

Under this plan, cooperatives would continue to report their allocated capital credits on the balance sheet as equity without regard to any obligation to retire the capital credits. The proposed reporting approach, if finalized, would essentially reverse prior FASB interpretations of SFAS 150 that co-op capital credits with a legal or constructive obligation to retire should be reported on the co-op balance sheet as a liability.

The FASB is now considering a requirement to report financial instruments with a direct ownership relationship, such as capital credits, that carry a settlement obligation as a separate line item of equity identifying the obligation to retire. If this proposal is ultimately adopted, however, unlike the earlier SFAS 150 liability treatment of capital credits, it should not impact the results of a co-op's financial ratios and tests.

[46] AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural Cooperatives*

At this writing, issues surrounding SFAS 150 continue to evolve. NRECA, CFC and RUS will continue to monitor and respond to the FASB's actions, and NRECA is participating in the FASB's Liabilities and Equity Resource Group to advise the FASB staff. (Current information on the status of SFAS 150 is available on Cooperative.com.)

CAN THE CO-OP USE UNCLAIMED CAPITAL CREDITS TO ADD VALUE FOR MEMBERS?

Former cooperative members should inform the co-op of any changes in address so that the co-op can locate them for future capital credits retirements. As a practical matter, many do not. If the co-op wishes to locate the member, Internet searches, national telephone directories and U.S. Postal Service records can help track them down.

If a former member does not claim retired capital credits, then state law governs the right to these unclaimed capital credits. Forty-four states have adopted an unclaimed property act. These acts provide for the state to take custody of (but not title to) property that is not claimed for a specified period of time. Escheat acts allow the state to take ownership of property that is abandoned or unclaimed for a specified period of time. In general, unclaimed capital credits are governed by an unclaimed property act, instead of an escheat act.

With regard to unclaimed capital credits, 27 states provide that unclaimed capital credits may remain with the cooperative; however, 10 of these states require that the funds be used for specific purposes, such as education, charity or economic development.

In the remaining states, there is apparently no specific statute addressing the co-op's ability to retain capital credits.

Cooperatives without authority to retain unclaimed capital credits have considered several approaches to reducing or eliminating unclaimed capital credits, such as applying a service charge, providing for voluntary or involuntary assignment or transfer of unclaimed capital credits to the cooperative if the member cannot be located in a specified period of time and requiring members to request capital credits retirements. Each of these approaches has unique legal considerations in determining its enforceability. If a co-op adopts such an approach and a court invalidates the action, the co-op may have to pay interest and penalties to the state as well as the full amount of the unclaimed capital credits.

Each cooperative should review its practices to be sure they are in compliance with appropriate law. Cooperatives that must render unclaimed capital credits to the state may want to consider requesting statutory relief.[47]

Some States Allow Cooperatives to Retain Unclaimed Capital Credits

State Law Provisions	States
Co-ops retain with no conditions	Alabama, Alaska, Arkansas, Florida, Idaho, Illinois, Indiana, Kansas, Michigan, Mississippi, North Dakota, Oklahoma, Oregon, South Dakota, Virginia, Washington, Wyoming
Co-ops retain with conditions	Colorado, Delaware, Iowa, Louisiana, Minnesota, Montana, New Mexico, Texas, Utah, Wisconsin
No express statute	Arizona, California, Georgia, Hawaii, Kentucky, Maine, Maryland, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Vermont, Virginia

[47] For more information, see Section II, Unclaimed Capital Credits in *Legal Issues Associated with Capital Credits*, available online at Cooperative.com.

Chapter 4: Compliance Issues

Questions for the Board's Consideration

- Is the co-op in compliance with federal laws and regulations affecting capital credits allocations and retirements?
- Is the co-op in compliance with state laws and regulations affecting capital credits retirements?
- Are the co-op's capital credits policies in compliance with the requirements of lenders?
- Are the co-op's capital credits policies compatible with the requirements of the financial markets?

A cooperative's policies for allocating and retiring capital credits should be in compliance with applicable state and federal laws as well as the co-op's articles of incorporation and bylaws. The policies should 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.

IS THE CO-OP IN COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS AFFECTING CAPITAL CREDITS ALLOCATIONS AND RETIREMENTS?

Federal laws provide special tax rules to recognize the value of cooperative businesses. IRC Section 501(c)(12) grants tax-exempt status to electric and telephone cooperatives, among others, if certain conditions are met. IRC Section 1381-1388 (Subchapter T) applies to most other cooperatives. While these cooperatives are taxable, Subchapter T allows them a tax deduction for patronage-sourced income allocated to their patrons if the requirements regarding allocations of patronage capital and other conditions are satisfied. Electric and telephone cooperatives that do not qualify for tax exemption under Section 501(c)(12) are not subject to Subchapter T and are governed by co-op case law established before Subchapter T was enacted in 1962.

Recommendation

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.

Mutual Company or Cooperative?

IRC 501(c)(12) provides a federal income tax exemption to certain mutual companies and cooperatives that meet other requirements. What's the difference? Both are organized to provide services—often those that would not otherwise be available—to member-owners essentially at cost. The key difference is how they treat any margins collected.

A **mutual company** uses any margins above the cost of providing services to reduce costs in future years. Examples of mutual companies include mutual insurance associations, such as State Farm Insurance, and credit unions, such as the Agriculture Federal Credit Union. There are also a number of mutual electric associations.

A **cooperative** returns its margins to the members through capital credits allocations and retirements.

Income Tax Consequences of Various Forms of Organization

Governing Authority	**Exempt Electric Co-op** IRC Sec. 501(c)(12)	**Taxable Electric Co-op** Pre-'62 Co-op Case Law	**Taxable General Co-op** IRC Sec. 1381 (Sub T)
Requirements to Qualify	Engage primarily in "like organization" activities (utility and ancillary services). Non-like income is non-member income; Operate as a cooperative. Meet the 85-percent member income test.	Operate on a cooperative basis; Receive more than 15 percent non-member income (or have exempt status revoked); Serve in "rural areas" as defined in Sec 5 of the RE Act.	1. Operate on a cooperative basis. 2. Not primarily engaged in providing electric and telephone service to "rural areas."
Determination of Co-op Taxable Income	Exempt for income tax on activities "substantially related" to tax-exempt purpose. Taxable on unrelated business income (UBI).	Segregate income and deductions between patronage and non-patronage-sourced activities. Exclude from income any assigned capital credits with respect to patronage-sourced activities.	1. Segregate income and deductions between patronage and non-patronage activities. 2. Deduct capital credits on patronage income (paid minimum of 20 percent cash with remainder written assignment—qualified). 3. Deduct non-qualified written allocations of capital credits on patronage income when paid in cash.
Tax Effect of Capital Credits on Member	1. Co-op is not required to issue Form 1099. 2. If a business, capital credits refund is includable in taxable income at redemption, not allocation.	Co-op is required to issue Form 1099-MISC at redemption over $600. If a business, capital credits refund is includable in taxable income at redemption, not allocation.	Co-op is required to issue Form 1099-PATR over $10 for qualified notices made and non-qualified notices paid. Patron includes in income at assignment, or allocation, for qualified capital credits and at redemption for non-qualified.
Ability to Establish Diversified Activities within Co-op	1. Very limited. Ancillary activities are [a] insubstantial or [b] incident to and in furtherance of utility service. 2. Subject to UBI Tax, if not "substantially related" to tax-exempt purpose.	May engage in diversified activities so long as primary activity is still providing electric/telephone service to "rural areas."	May engage in diversified activities so long as majority of business is still with members (i.e., business is still a co-op).
Ability to Establish Subsidiary for Diversified Activities	According to Rev Rule 2002-55, a tax-exempt electric co-op may establish a for-profit subsidiary for valid business reasons without jeopardizing the parent's tax-exempt status; According to IRC 337(d) liquidation of for-profit subsidiary into tax-exempt parent results in taxable gain on assets appreciation.	No tax restrictions on formation of subsidiary; For-profit subsidiary income is non-patronage sourced, and hence, taxable. Tax-free liquidation of for-profit subsidiary into taxable parent.	No tax restrictions on formation of subsidiary. For-profit subsidiary income is non-patronage sourced, and hence, taxable. Tax-free liquidation of for-profit subsidiary into taxable parent.
Ability to File a Consolidated Tax Return (offsetting losses of subsidiary against taxable income of parent)	Consolidated return cannot be filed for tax-exempt organization.	Consolidated return is permissible.	Consolidated return is permissible.

*Source: IRS Regulations, Section 1 61-5

IRC Section 501(c)(12)

IRC Section 501(c)(12) exempts certain cooperatives, including electric and telephone cooperatives, and mutual companies from federal income taxation if they provide utility and related services to members, and if they pass the 85-percent test. While some Section 501(c)(12) utilities may choose to operate as mutual companies, the tax issues associated with mutual companies are beyond the scope of this report.

In order to qualify for the federal tax exemption under Section 501(c)(12), a cooperative must:

- Engage in specified activities,
- Operate under cooperative principles, and
- Derive 85 percent or more of their income from members annually.

Cooperative principles IRC Section 501(c)(12) does not define what it means to operate as a cooperative. The IRS has, however, adopted key principles[48] based on case law and experience, including:

- *Subordination of capital.* The members of the cooperative (unlike shareholders in an investor-owned firm) control the cooperative and share in any savings or financial benefits. Voting rights are based on membership—one member, one vote—rather than financial investment in the organization or use of services. Interest or dividends are not paid on members' equity investments.
- *Democratic control by members of the cooperative.* Members participate in policy- and decision-making for the organization. A co-op holds annual meetings for members to elect board members to operate the co-op, to approve certain matters affecting the governance of the cooperative and to otherwise participate in guiding the organization.
- *Vesting in and allocation of capital credits among the members.* The excess of a cooperative's operating revenues over its operating expenses belong to its members. The organization must allocate any operating margins to members in proportion to the amount of business done with the cooperative.
- *Operation at cost.* A cooperative must not operate for profit and should strive to avoid losses.

The 85-percent test Once the IRS issues a determination letter granting tax-exempt status, a co-op is exempt from federal income tax in any year in which it receives 85 percent or more of income from members for the sole purpose of meeting losses and expenses. There are two requirements for member income: it must be collected from members on a cooperative basis, and it must be derived from services specified in Section 501(c)(12).

If the co-op fails the test in a given year, it is subject to federal income tax for that year. However, it does not have to re-apply for exempt status if it continues to meet the other Section 501(c)(12) requirements. Thus a co-op could pass the test in Year 1, fail (and pay income taxes) in Year 2 and pass again in Year 3 without changing its status with the IRS.

It is possible—and it has happened with a few G&T's—for the IRS to revoke tax-exempt status if an agent auditing the cooperative sees evidence that the co-op is unlikely to pass the 85 percent test in the foreseeable future.

Other issues Exempt electric cooperatives are required to pay federal taxes on any unrelated business income. For example, sales and service of appliances to customers who do not purchase electricity from the cooperative generate unrelated income, which is subject to taxation.[49]

Exempt cooperatives are also subject to restrictions on diversified activities. Generally, any income from activities that do not qualify for exemption must be treated as non-member income for purposes of the 85-percent member income test, even if the customer is a member of the cooperative.

[48] Exempt Organizations: Proposed Examination Guidelines Regarding Rural Electric Cooperatives, Announcement 96-24, 1996.
[49] Exempt Organizations: Proposed Examination Guidelines Regarding Rural Electric Cooperatives, Announcement 96-24, 1996.

Many cooperatives are concerned about the consequences of failing the 85-percent test. While the co-op would have to pay income taxes on non-patronage-sourced income (approximately equivalent to non-member income), patronage-sourced income is eligible for exclusion from federal gross income and may, therefore, be nontaxable, provided the cooperative properly notified members of the dollar amount of annual capital credits allocations. For most cooperatives, the remaining taxable income is likely to be relatively small, and the financial impact of losing tax-exempt status maybe minimal under today's circumstances.

Of greater concern is the possibility of a cooperative losing its status as a "cooperative" under federal tax law. In that case, member and nonmember income would be taxed separately under the provisions of IRC 277, the statutory provision that applies to membership organizations that are not tax-exempt under other sections of the tax code. The financial impact of that occurrence could be substantial. It is, therefore, important for the cooperative to protect its status as a cooperative by meeting the IRS requirements for operating as a cooperative.

As the competitive structure of the electric utility industry continues to evolve, some cooperatives may find themselves earning non-member revenues from new sources. In assessing the impact of any new development, co-ops must determine whether it affects the 85-percent test.

Subchapter T

Cooperatives organized under IRC Section 1381, Subchapter T generally operate on a taxable basis. Subchapter T cooperatives are primarily engaged in providing services other than electric and telephone service in rural areas. While some electric cooperatives have organized Subchapter T cooperatives to provide non-electric services, discussion of the issues associated with Subchapter T co-ops is beyond the scope of this report.

Pre-1962 Co-op Case Law

An electric cooperative that fails the 85-percent member income test is considered by the IRS to be taxable. Unlike most taxable cooperatives, however, taxable electric cooperatives are generally not subject to the provisions of Subchapter T, *provided* that they serve "persons in rural areas."[50] Instead, the taxable income of such taxable electric cooperatives is determined under administrative and case law in effect prior to the passage of Subchapter T in 1962 (pre-62 co-op case law). Taxable rural electric co-ops are generally allowed to exclude from federal gross income capital credits that have been allocated to patrons from patronage-sourced income, reducing tax liability, provided the cooperative properly notified members of the dollar amount of the capital credits allocations.

Tax regulations provide that the term "rural area" is the same as the term is defined in Section 5 of the Rural Electrification Act of 1936, as amended.[51] These tax regulations do not specify, however, how much of a cooperative's service area or what percentage of the cooperative's patrons must meet this "rural area" test, so the tax treatment of taxable electric cooperatives that serve in both rural and urbanized areas is an undecided issue.

IRC Section 501(c)(12), which contains the provisions required for an electric cooperative to be tax-exempt, includes no "rural area" requirement. Furthermore, neither qualification for tax-exemption under IRC Section 501(c)(12) nor the applicability of Subchapter T is dependent on whether the cooperative is an RUS borrower.

[50] IRC Section 1381(a)(2)(C)
[51] IRC Section 1.1381-1Cb(4)

Revenue Ruling 72-36, 1972-1 CB 151 — IRC Sec. 501

Reference(s): Code Sec. 501 Reg Sec. 1.501(c)(12)-1

Certain requirements that cooperative companies must meet for exemption under section 501(c)(12) of the code are explained.

Full Text The Internal Revenue Service has received inquiries from cooperative companies regarding certain requirements for exemption from federal income tax under section 501(c)(12) of the Internal Revenue Code of 1954.

Section 501(c)(12) of the code provides for exemption from federal income tax of mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, if 85 percent or more of their income consist of amounts collected from members for the sole purpose of meeting losses and expenses.

Section 1.501(c)(12)-1(a) of the Income Tax Regulations provides that excess funds on hand at the end of the year may be retained to meet future losses and expenses, or returned to members.

The specific questions and their answers are as follows:

Question 1 Should the interests of members in the savings of an organization be determined in proportion to their business with the organization?

Answer Yes. In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.

Question 2 Can funds be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes?

Answer Yes. However, such funds may not be accumulated beyond the reasonable needs of the organization's business. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.

Question 3 Where an organization retains funds for purposes other than meeting current losses and expenses, must the organization's records show each member's rights and interest in the funds it retains?

Answer Yes. To maintain its mutual or cooperative character an organization must keep such records as are necessary to determine, at any time, each member's rights and interest in the assets of the organization.

Question 4 What is the effect on exemption of a forfeiture of a former member's rights and interest where the bylaws provide for such forfeiture upon withdrawal or termination?

Answer If, under the bylaws, a member's rights and interest have been forfeited, the organization has not operated on a mutual or cooperative basis and is therefore not exempt.

Question 5 Where, upon dissolution, an organization has gains from the sale of an appreciated asset, how should these gains be distributed?

Answer Such gains should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.

IS THE CO-OP IN COMPLIANCE WITH STATE LAWS GOVERNING CAPITAL CREDITS?

Enabling Legislation

A cooperative is organized under the laws of the state in which it is incorporated.[52] Traditional electric cooperatives are incorporated and operate in 47 states. The state issues articles of incorporation authorizing the cooperative to be formed and conduct business. Electric cooperatives in approximately 30 states are organized under specific electric cooperative acts. Twenty-eight of these acts address what happens to excess revenues, effectively governing the allocation and retirement of capital credits. Fourteen of these acts contain language similar or identical to the language in Model A; six, Model B; and five, Model C (see below).

Electric cooperatives in 11 states are incorporated under a general cooperative act; in three states, they are incorporated under a nonprofit corporation act; and in three states, under a business corporation act. Most general cooperative acts address excess revenue. Most nonprofit or business corporation acts do not, but they authorize bylaws that may address treatment of excess revenues.

Capital Credits Policies of Electric Cooperatives May Be Governed by State Statutes

The 28 electric cooperative acts that address excess revenues contain language similar or identical to the language adopted in Model A, Model B or Model C.

Model A, 14 States

Alabama, Florida, Kansas, Louisiana, Maine, Maryland, Missouri, Montana, New Mexico, New York, Oklahoma, South Carolina, Tennessee, Vermont

Revenues of a cooperative for any fiscal year in excess of the amount thereof necessary:

1. To defray expenses of the cooperative and of the operation and maintenance of its facilities during such fiscal year;
2. To pay interest and principal obligations of the cooperative coming due in such fiscal year;
3. To finance, or to provide a reserve for the financing of, the construction or acquisition by the cooperative of additional facilities to the extent determined by the board of directors;
4. To provide a reasonable reserve for working capital;
5. To provide a reserve for the payment of indebtedness of the cooperative maturing more than one year after the date of the incurrence of such indebtedness in an amount not less than the total of the interest and principal payments in respect thereof required to be made during the next following fiscal year; and
6. To provide a fund for education in cooperation and for the dissemination of information concerning the effective use of electric energy and other services made available by the cooperative

shall, unless otherwise determined by a vote of the members, be distributed by the cooperative to its members as patronage refunds prorated in accordance with the patronage of the cooperative by the respective members paid for during such fiscal year. Nothing herein contained shall be construed to prohibit the payment by a cooperative of all or any part of its indebtedness prior to the date when the same shall become due.

[52] For more information, please see Section B-2, State Capital Credit Statutes in *Legal Issues Associated with Capital Credits*, available online at Cooperative.com.

Model B, 6 States

Arkansas, Mississippi, Nebraska, North Dakota, Pennsylvania, Texas

The revenues of a cooperative shall be devoted first to the payment of operating and maintenance expenses and the principal and interest on outstanding obligations, and thereafter to such reserves for improvement, new construction, depreciation, and contingencies as the board of directors may from time to time prescribe. Revenues not required for these purposes shall be returned from time to time to the members on a pro rata basis according to the amount of business done with each during the period either in cash, in abatement of current charges for electric energy, or otherwise as the board of directors determines. This return may be made by way of general rate reduction to members if the board of directors so elects.

Model C, 5 States

Alaska, Arizona, Kentucky, South Dakota, Virginia

A cooperative shall be operated on a nonprofit basis for the mutual benefit of its members and patrons. The bylaws of a cooperative or its contracts with members and patrons shall contain such provisions relative to the disposition of revenues and receipts as may be necessary and appropriate to establish and maintain its nonprofit and cooperative character.

In addition, the Model C is identical to section 23 of the Rural Electrification Administration's January 3, 1949, Uniform Electric Cooperative Act.

Other Approaches

Cooperative Act
California, Colorado, Hawaii, Iowa, Michigan, Minnesota, Nevada, Oregon, Utah, Washington, Wisconsin

Business Corporation Act
Delaware, New Jersey, West Virginia

Nonprofit Corporation Act
Idaho, Illinois, Ohio

Unique Electric Cooperative Act
Georgia, Indiana, Wyoming

Does Not Address Capital Credits
New Hampshire, North Carolina

No Electric Cooperatives
Connecticut, Massachusetts, Rhode Island

State Public Service Commissions

Cooperatives in 43 states are subject to some form of state regulation, including 24 states that exercise some degree of statutory authority over rates. State commissions may have regulations, policies or rulings affecting capital credits allocations and retirements. For example, the Arkansas Public Service Commission regulates Arkansas Electric Cooperative Corporation (AECC), a generation and transmission cooperative, and its 17 member distribution cooperatives. The commission requires three distribution cooperatives to make capital credits retirements to their consumer members any time they receive a capital credits refund from AECC. Requirements like this can affect financial planning, capital credits allocation procedures and other aspects of the distribution systems' operations.

In reviewing and revising capital credits policies, each system has an obligation to be aware of and comply with any state regulatory requirements.

ARE THE CO-OP'S CAPITAL CREDITS POLICIES IN COMPLIANCE WITH THE REQUIREMENTS OF LENDERS?

RUS

Since the early days of the rural electric program, RUS has maintained a philosophy that borrowers should achieve an adequate level of equity before retiring capital credits in order to ensure financial stability and the co-op's ability to repay its RUS loans. Recognizing that capital credits retirements can also be an important tool for ensuring the success of the cooperative, RUS has, over time, reduced the threshold requirements for retirement without prior approval.

RUS operational control regulations[53] grant prior automatic approval for capital credits retirements if the borrower's equity will be equal to or greater than 30 percent of total assets after the retirement. Otherwise, capital credits retirements require specific approval. This regulation is important because it provides a mechanism for borrowers subject to older loan documents to retire capital credits without obtaining additional approvals.

The current RUS loan contract[54] allows borrowers to retire capital credits if:

- The co-op's equity level will be equal to or greater than 30 percent of total assets after the retirement, or
- The co-op's equity level is greater than 20 percent and the total amount of all distributions during the calendar year are equal to or less than 25 percent of the prior year's margins.

Regardless of its equity level, a borrower also may make retirements to estates. Otherwise, a cooperative must obtain written approval to make capital credits retirements.

Borrowers who have failed to make payments on RUS debt or are otherwise in default of their loan documents with RUS are prohibited by both regulations and the current loan agreement from making capital credits retirements under any circumstances.

CFC

CFC's loan covenants allow borrowers to retire patronage capital provided equity will be equal to or greater than 20 percent after the retirement. If equity will be less than 20 percent, the borrower may retire up to 30 percent of the previous year's margins. Borrowers who are in default of payments or other loan agreement provisions may not retire capital credits.

[53] 7 C.F.R. 1717.67 (2004)
[54] Loan Contract with Distribution Borrowers. Sec. 6.8 Limitations on Distribution. 7 C.F.R. pt. 1718, subpt. C. app. A (2004)

ARE THE CO-OP'S CAPITAL CREDITS POLICIES COMPATIBLE WITH THE REQUIREMENTS OF THE FINANCIAL MARKETS?

The cooperative network's financial performance, collectively and individually, affects both access to and cost of funds from the financial markets. Whether a system approaches the markets directly or works through CFC—whose ability to raise funds depends directly on member performance—effective equity management contributes to a positive view from the financial community.

Fitch Ratings met with the task force to discuss its current analytical approach to evaluating electric cooperatives. The rating agency, which primarily rates G&T cooperatives, also discussed its views of distribution systems. Fitch takes a balanced approach in assessing key credit factors, looking for adequate financial strength for both the G&T cooperative and its member systems. In evaluating financial protection for lenders, it looks for:

- Adequate cash flow coverage,
- Strong equity position,
- Liquidity,
- A well-defined business plan, and
- An experienced management team and board.

Fitch does not rely solely on ratio targets to assign a rating category. However, for an A rating it would usually expect a G&T system to achieve:

- Equity of about 20 percent,
- Annual TIER and DSC of about 1.25, and
- Liquidity of about 60 days of operating expenses.

In terms of overall distribution system performance, assuming systems of reasonable quality with average credit features in terms of size, demographics, cost of power, retail rates and other factors, Fitch told the Capital Credits Task Force that the following ranges of financial ratios would be appropriate for an investment grade rating:

- 30 to 50 percent equity,
- Debt to funds available for debt service (FADS) of 10 or less,[55]
- Liquidity sufficient to meet 45 to 75 days of operating expenses, and
- Annual TIER and DSC of 1.5 to 2.0 or higher.

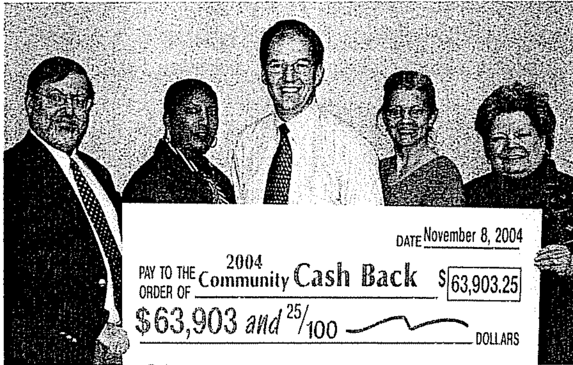
With regard to capital credits, Fitch says that the ability to be flexible in the timing and amount of payments made to customers is looked upon most favorably. Having control over the payments gives the systems the ability to build equity more quickly and provides another tool for managing liquidity over the longer term.

In developing its equity management plan, each system has to establish a target range for its performance based on its own operating environment.[56]

[55] FADS=operating income plus interest income plus depreciation
[56] Written comments from Fitch Ratings are available online at **Cooperative.com**.

Learn from Experience
Connexus Gives Capital Credits Cash Back to Members

Connexus Energy, Ramsey, Minnesota, uses capital credits retirements to connect with members and the local community under a program it calls Cash Back. "It's designed to be a central part of how customers relate to us," said Mike Bash, Connexus Chief Financial Officer. "We call it Cash Back to try to gain value recognition of why the cooperative way of doing business is a better deal."



(Left to Right): Michael McGlone, Salvation Army Heat Share; Karen Barber, American Red Cross; Mike Bash, Connexus Energy; Ann Olson Bercher, Minnesota Historical Society; Judy Karmack, Habitat for Humanity.

The original Connexus bylaws required the co-op to use the First-in, First-out (FIFO) method of retiring capital credits. "Only 12 percent of our customers were getting any cash back under the FIFO method," Bash said. "We wanted to maximize the number of current customers that were receiving capital credits."

Connexus amended its bylaws in 1994 to allow the board of directors to determine the method of capital credits retirement. In 2002, the co-op introduced Cash Back, a percentage-based retirement approach that ensures that virtually 100 percent of customers have the opportunity receive a capital credits retirement—Cash Back—or to donate the amount to one of four community organizations. "We are trying to balance getting money to current customers with acknowledging the obligation we have to former members to return their capital."

It takes about three months to carry out the Cash Back process. After the co-op completes the analysis detailing the Cash Back refunds, it sends a mailer to members notifying them of the amount and giving them the choice of the bill credit or donation. If the consumer chooses to keep the Cash Back, no action is needed. Consumers who choose the donation return a post card included with the mailer. Then the co-op credits bills and makes the contributions.

In 2004, 5,120 consumers donated almost $64,000 of more than $2.7 million in Cash Back payments to:

- Salvation Army Heat Share, a program that provides utility payment assistance;
- Habitat for Humanity, an organization that builds affordable houses;
- American Red Cross, a local chapter that provides humanitarian services in the community; and
- Minnesota Historical Society, proprietors of a local heritage farm.

These organizations were selected because their work relates to the co-op's role in the community. "The local symphony orchestra may be really important to the community, but it doesn't have a relationship to our role as a utility," Bash said. The co-op holds a ceremony to present the check to each organization, providing a photo opportunity that generates newspaper articles and positive press coverage. Member contributions made through Cash Back are tax-deductible.

The cooperative promotes the program through the mailer, the Connexus Web site, bill envelopes, the bill itself, newsletters and newspaper ads. "It is part of our year-round message that you get Cash Back from your electric utility. That is a distinguishing point, and the community giving fits with other things we do throughout the year," Bash said.

Chapter 5: Maximizing the Benefits of Capital Credits Decisions

Questions for board consideration

- **What should a co-op know about its members?**
- **How can the co-op use capital credits retirements to communicate with members about the value of cooperative membership?**
- **What is the best time to issue capital credits retirements?**
- **What is the best method for issuing capital credits retirements?**

Members, nonmembers and the public respond very favorably to the concept, principles and values that electric cooperatives offer consumers. In developing and implementing a capital credits policy, co-ops sometime overlook the opportunity to distribute capital credits payments in a way that will build member loyalty and educate consumers about the advantages of cooperative membership.

Learn from Experience
South Plains EC Tells the Cooperative Story

Whether it's through a promotional stuffer, a newspaper ad, or the local pages of its statewide magazine, South Plains Electric Cooperative in Lubbock, Texas, makes sure its 23,000 members understand the cooperative difference.

In September each year, just before their annual meeting, South Plains EC includes a catchy promotional stuffer with its mailing of capital credits checks to members. "We take this opportunity to differentiate our co-op from the other utility providers in our area," said South Plains EC Manager of Communications Lynn Simmons. "The stuffer is not highly technical—it mainly promotes how we operate differently as a co-op. The front side provides general information but members can flip it over and see enough detail that they can actually calculate their own retirement."

South Plains EC also educates its members about capital credits by providing comprehensive information in its annual report, which is part of the local pages in its Texas statewide magazine, *Texas Co-op Power.* "An entire page is devoted to explaining capital credits, why we have them, and how they make us different," Simmons said. "We also include a history of our allocations and refunds."

The co-op uses a FIFO/LIFO hybrid for retiring capital credits. "Last year we retired about a million dollars, representing half of our allocated margins for our most current year and half from previous years," said the co-op's Director of Finance and Administration Ronnie Rucker. "We've been experiencing heavy residential growth so many of our members have been members for less than five years. Many of them don't realize that they are part of a co-op. Usually within a year or two, a new member will receive their first capital credits check, and we feel this is a great way of demonstrating the benefits of belonging to South Plains."

South Plains also decided to reach out to both members and nonmembers to tell the cooperative story with a series of capital credits ads in 14 local newspapers. Each ad carried the same message but the photography was customized for the co-op's different types of members. "Our system is basically divided equally between residential, small commercial, irrigation and large industrial—in our case, oil companies," Simmons said. "As a Touchstone Energy co-op, we have very affordable access to a huge library of photos. We were able to have the photo in each ad speak directly to each of these members."

South Plains misses no opportunities to make sure that every member has the chance to learn what it means to be an owner of their electric utility. "Our goal is to consistently make ourselves visible as a community partner," Simmons said. "We just keep telling the story."

Recommendation
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.

WHAT SHOULD A CO-OP KNOW ABOUT ITS MEMBERS?

Basic knowledge of the characteristics of its membership can help a co-op devise capital credits policies and communications programs that will maximize the benefit of capital credits retirements. Research shows that two of the most important characteristics are tenure of membership and age.

Tenure of Membership

According to the U.S. Census Bureau, 40.1 million U.S. residents—14.2 percent—moved between 2002 and 2003. While that is a decline from the 17 percent moving in 1994, it demonstrates that geographic mobility is an important aspect of American life.

The bureau also found that moving rates varied by the characteristics of the movers.

- Young adults had the highest moving rates with about one-third of 20-29-year olds moving—more than twice the rate of the population as a whole.
- Non-Hispanic whites were less mobile than other race and Hispanic-origin groups.
- Almost one-third of renters moved.
- People with income below poverty were more likely to move than those above poverty.

Fifty-nine percent of the moves were within the same county while 19 percent were to a different county within the same state; 19 percent were to a different state; and 3 percent were from abroad. In addition, the bureau found that 32.3 percent of the movers moved less than 50 miles. The median distance was 155.3 miles. The Midwest and Northeast regions experienced net migration losses of population while the South and the West had net migration gains.[57] While this information cannot be generally applied to an individual cooperative, it does confirm that many co-ops are likely to experience significant turnover every year. Census data is available in many forms down to individual blocks and can help a co-op understand the characteristics of its new members.

Age

Touchstone Energy recently completed a member attitude survey of the membership of five electric cooperatives. A substantial majority of those surveyed in all age groups agreed that it was an important value for cooperatives to give money back to their customers when operating revenues exceed costs. However, the number of those surveyed who strongly agreed that co-ops actually give money back to consumers varied substantially across age groups with younger members being much less likely to agree than older members. The results indicate an opportunity for these cooperatives to use capital credits refunds to demonstrate to younger members that cooperatives operate in accordance with their values.

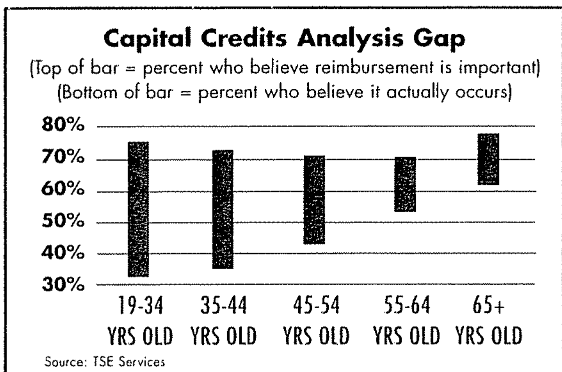
[57] U.S. Census Bureau, *Geographical Mobility: 2002 to 2003*, March 2004. Detailed census information is available at www.census.gov

Research Shows Age Matters

Touchstone Energy recently commissioned TSE Services, a market research firm owned by North Carolina's electric cooperatives, to study consumer attitudes. The researchers presented the following statement to members of five electric cooperatives:

"Cooperatives give money back to their customers when revenues exceed costs."

A significant majority of consumers in all age groups ranked this as a very important value. When asked whether they agreed with the statement, the differences among age groups were striking. As few as 33 percent of members under age 35 strongly agreed with the statement, yet 75 percent of that group reported the attribute as very important. The results indicate a need to develop stronger connections with younger members.



The majority of consumers of all ages agree that it is important for cooperatives to give money back to consumers. However, younger consumers are much less likely to perceive that co-ops actually do return funds to consumers

In addition, a key drivers analysis done as part of this survey shows that giving money back to consumers contributes significantly to their perception of receiving a good value for the money they spend as well as their sense of membership. These perceptions have been shown to contribute strongly to high levels of satisfaction and customer loyalty.

While these results are specific to the original five participants, the results have been confirmed in efforts completed since the Touchstone study. Other co-ops may find it interesting to explore the attitudes of their younger members using similar methods.

Understanding population trends and viewpoints can help co-ops devise policies and communication materials that tie the co-op to its members more strongly. For example, co-ops with a growing Hispanic population may want to develop Spanish language materials. Co-ops with a very transient population may want to develop programs that target newcomers and younger members. The point is that co-ops must know their members in order to connect with them.

HOW CAN THE CO-OP USE CAPITAL CREDITS RETIREMENTS TO COMMUNICATE WITH MEMBERS ABOUT THE VALUE OF COOPERATIVE MEMBERSHIP?

Communicating with Different Audiences

A cooperative has to communicate its message about capital credits to several different audiences. The message should be tailored to fit the needs of those different audiences and timed for the maximum benefit.

Cooperative employees As soon as the co-op has determined the amount of capital credits it plans to retire, the manner and timetable, the cooperative should educate and inform the employees of the decision. It should be kept in mind that the employees are the frontline contact with the membership, and members will ask them questions regarding the co-op's capital credits retirement plans.

Neighboring cooperatives Once the cooperative has finalized its capital credits retirement strategy and plans, the cooperative should notify those electric cooperatives bordering their service areas and the statewide association of the board's decision. This advance notice will help them be prepared to respond to inquiries about their own equity/capitalization needs that their members might present upon learning of the neighboring cooperative's plan.

The cooperative's members The cooperative should carefully contemplate formulating answers to the questions consumers might ask. In addition, once the co-op announces the retirement of capital credits and distribution of checks, it should be prepared to handle a significant number of inquires from heirs and others who will claim to have the right to some former member capital credits. This also will include spouses of former members who have since divorced.

Media At the time the cooperative makes its initial announcement about retirement of capital credits, it should inform the media that cover the cooperative's service area about the amount of capital credits to be retired, the timetable and overall dollar amount of the retirement. The media, too, will need to be educated about capital credits and the value they bring to the membership and the cooperative business.

Public officials It is a good idea to alert state and federal legislative representatives about the cooperative's intentions. Such advance information can build a stronger awareness among these elected officials of the cooperative's commitment to the membership and community's economic well-being.

Studies have found that loyalty among consumers who identify with being a member of the cooperative is stronger than that of those who identify only with being a satisfied consumer. A member education and communication program that explains why co-ops are a different kind of utility and what benefits a consumer gains from being served by a cooperative is essential to fostering member identity. It is a long-term process that requires a long-term investment of time and energy as well as money. It also means that the co-op must operate in a way that embraces cooperative principles of member ownership, control and economic participation.

The act of distributing capital credits retirements offers an opportunity to address the special value of co-op membership. A well-designed capital credits retirement procedure will include a communications plan to help members understand what they are receiving. Capital credits are the members' investment in the cooperative. The investment has provided part of the capital needed to operate the co-op. By making that investment, members have reduced the cost of electricity for themselves and the other members. Capital credit retirements represent the return of that investment.

Communications materials should answer questions the member might have 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?

Unclaimed capital credits may provide another opportunity to demonstrate the value of cooperative membership. If state laws allow the cooperative to retain unclaimed capital credits,[58] the co-op may designate a special purpose for these funds, such as a scholarship program for students from cooperative families.

[58] See page 59.

Research Shows Members Unaware of Cooperative Difference

In May 2001 (during the California energy crisis), Peter D. Hart Research Associate, Inc., conducted seven focus group sessions in California, Texas, Kentucky and North Carolina, followed by a survey in June and July of more than 1,600 consumers, including co-op members and customers who purchase electricity from another type of supplier. The study was designed to elicit information that would help co-ops succeed in a competitive environment.

The study found that most American consumers were happy with their electric utility, regardless of the type of supplier, and that consumers believe that they can expect better service from a co-op. The study also found that consumers are not knowledgeable about the special nature of co-ops.

"The general public is largely unaware of the co-op option, and co-op members themselves are not tightly bonded to their co-op," the Hart report said. The report goes on to say, "Co-ops have two broad message themes to sustain themselves:

- Co-ops reliably provide energy at a reasonable cost.
- Co-ops are special organizations whose values mean better service for their members—the owners."

The researchers concluded that co-ops are doing well in making the first argument—but so are other electric utilities. They recommended that co-ops concentrate on the second message by building greater awareness of the values and heritage that make co-ops unique among electric providers.

While the project did not specifically address the issue of capital credits, a co-op can structure the capital credits retirement process to convey the message that the co-op is connected to the community and that it treats member-consumers with respect.

Source: Peter D. Hart Research Associates, Inc

Research Shows Fostering Member Identity Pays

The NRECA Market Research Services analyzed randomly selected samples of responses from 22,244 residential co-op members and 4,268 other residential electric customers aggregated from customer satisfaction and attitude studies conducted for co-ops from late fall 1999 through 2001. The consumers represented a diverse geographic area nationally. The purpose of the study was to determine whether there are benefits for electric service providers that are cooperatives and that are recognized by their customers as cooperatives.

The study found that co-op members who have some level of identity as member-owners of their co-op are more satisfied and loyal than both the members who do not have that sense of identity and members who don't know that their provider is a cooperative. This finding held true across the various demographic groups studied.

The study found that "Fostering member identity pays dividends in terms of satisfaction and loyalty to co-ops." The study concluded that having members who have an identity as member-owners pays dividends in satisfaction and loyalty.

While this study did not analyze capital credits specifically, capital credits are a valuable tool that can help forge a strong identity among consumers that they are indeed also members and owners of a cooperative that is responsive to their needs.

Source: NRECA Market Research Services

Learn from Experience
It's PEC Day in Oklahoma!

The annual meeting of Peoples Electric Cooperative is such a big event that the mayor of Ada, Oklahoma, declared it PEC Day. The 13,000-member co-op, which serves 11 counties in south central Oklahoma, draws an annual meeting attendance of 7,000 to 9,000 people, representing about 3,000 co-op members, every year.

How they do it? "It isn't easy—it's a lot of work!" said PEC Executive VP and General Manager Randy Ethridge. "The biggest factor is that we personally hand each member that attends the meeting their capital credits retirement check." Members travel as much as an hour each way to attend the meeting and receive their check.

With the help of most of its employees and police and other services provided by the city, PEC sponsors one of the biggest social gatherings of the fall season in the area. It's a family affair. Members and their guests enjoy live musical entertainment, prizes, arts and crafts booths, activities for the kids, and a smorgasbord of food provided by local vendors. And even though doors don't open until 9 a.m., members start lining up before 7:30 a.m. so they can register and pick up their share of the co-op's margins for the year.

"This event takes lots of planning and support from employees and the local community," Ethridge said. "We have 40 employees working 20 to 25 registration lines and registering members, thanking them for their support and handing them their checks. The logistics are mind boggling, but every year it works and we build member support and goodwill." Attendance continues to increase each year. Twenty years ago, the co-op had difficulty obtaining a required 5-percent quorum. Now, the meeting easily draws 25 to 30 percent of its membership. The co-op is confident that it will easily surpass a quorum at every annual meeting.

PEC uses a FIFO/percentage hybrid for retiring capital credits. Last year, the co-op's board decided to retire 20 percent of its current-year margins. "This amounted to an average check of $50 to $75 per member. Many local merchants offer special promotions on PEC Day to encourage members to spend their check right away and, in fact, we have so many people attending the meeting that we provide satellite transportation from many local shopping centers in the area," Ethridge said.

For this co-op, the annual meeting presents an opportunity to demonstrate to their members that they own the business and that it does make a difference.

WHAT IS THE BEST TIME TO ISSUE CAPITAL CREDITS RETIREMENTS?

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, such as:

- In December before the holidays,
- At the end of the school year,
- During the peak season for utility bills,
- In conjunction with the annual meeting, or
- In October during National Cooperative Month.

Learn from Experience
Sioux Valley Energy Spreads Post-holiday Cheer with Bill Credits

Along with post-holiday bills, members of Sioux Valley Energy, Colman, South Dakota, find a pleasant surprise in their January mailboxes: a credit on their electric bill for their capital credits retirement. Some co-ops are afraid customers will not recognize refunds issued through bill credits, but that hasn't been a problem at Sioux Valley. To be sure customers don't miss it, the co-op includes a bright yellow bill insert explaining the retirement and what it represents. The refund also is publicized in the co-op's newsletter and statewide magazine. The co-op issues checks to consumers who have left the system.

Consumers like this approach, according to Eunice Bartels, board vice president. "We have had a good response to this method of retiring our capital credits," she said. The co-op likes the savings over issuing checks—more than $5,900 in postage in 2004 and additional savings as a result of not purchasing and processing checks.

The cooperative undertook a review of its capital management practices in 2002 to evaluate the impact of several factors. The co-op is experiencing growth and is also investing heavily in plant maintenance and line replacements. In addition, it wants to increase its equity level to help reduce the cost of borrowing funds. As a result, the board decided to reduce the amount set aside for annual capital credits retirements from 5 percent of total equity to 2.5 percent, including the estate retirements.

The co-op uses the FIFO/LIFO method for general retirements, retiring 70 percent of the oldest capital credits on the books and 30 percent of the most recent year allocated.

In 2004, Sioux Valley issued bill credits to 15,994 members and checks to 5,062 members for a total of $585,000 in general capital credits retirements. The co-op also retires capital credits to estates throughout the year.

The co-op evaluates its financial condition each year to determine whether capital credits retirements are prudent. "Repayment of capital credits will remain a year-to-year decision for the board," said Don Marker, General Manager. "We're happy that our strong financial condition made these retirements possible."

WHAT IS THE BEST METHOD FOR ISSUING CAPITAL CREDITS RETIREMENTS?

The co-op can issue the retirement as a check or bill credit. There are advantages and disadvantages to each approach. A check provides a more tangible demonstration of the return, but the administrative costs are higher. A bill credit may be overlooked on the bill, but it is a less costly approach.

Check or Bill Credit?

Capital credit retirements issued through either a check or a bill credit can provide an opportunity for positive interaction with members. The key is to have a well-thought-out plan for using the retirement to emphasize the benefits of cooperative membership.

Retirement Format	Advantages	Disadvantages
Check	• Tangible evidence of ownership • Marketing flexibility	• Higher administrative costs
Bill Credit	• Lower administrative costs	• Easy to overlook on bill • Must still send check to inactive patrons receiving a retirement

A co-op may decide to take different approaches with different customer classes. One way to focus attention on patronage capital retirements is to make a formal presentation of large capital credits checks, especially to visible institutions like schools or hospitals, and encourage media coverage. This can help maintain good relations with large accounts and also educate the membership as a whole.

A co-op's capital credits policy can be a valuable tool for building greater awareness of the values and heritage that make cooperatives unique among electric providers.

Chapter 6: Conclusion and Recommendations

The primary purpose of the task force is to educate boards of directors about current capital credits issues and encourage co-ops to review capital credits policies. While each cooperative has unique circumstances that affect its capital credits decisions, there are also common issues. In this report, the task force has provided alternative approaches to many of these issues. However, the task force recognizes that its work would not be complete if it did not make recommendations on issues when it believes that the appropriate action is clear and applicable in most situations. It is the task force's hope that these recommendations will help co-ops meet capital credits obligations in a way that strengthens the value of all cooperatives.

WHAT ARE THE RECOMMENDATIONS OF THE CAPITAL CREDITS TASK FORCE?

While there are many aspects to the process of developing a capital credits policy, the board of directors has two basic responsibilities: to establish strategic goals for the co-op's capital credits policy and to determine the techniques for allocating, retiring, refunding and communicating with members about capital credits that will be most effective in helping the co-op achieve these goals while complying with applicable laws, regulations and the co-op's own bylaws. The task force has adopted recommendations to address each of these areas.

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.

Members have an economic stake in the cooperative. Through rates, they invest funds in the cooperative that enable them to receive services that might not otherwise be available. The return of that investment through the allocation and retirement of capital credits is one of the concepts that defines a cooperative and distinguishes it from another form of business. It also helps to ensure that each generation of consumers provides its own capital. Various federal and state laws and regulations as well as many cooperatives' articles of incorporation and bylaws also address capital credits requirements.

The 1976 Capital Credits Study Committee recommended that electric cooperatives retire capital credits: "In order to develop a sense of ownership on the part of the members and to reward our members for the capital they contribute, capital credits should be retired even though the amounts in any given year may be relatively small."[59]

That statement continues to be true. Capital credits provide a tangible demonstration of the value of the cooperative form of organization and of the benefits of cooperative membership.

A checklist to assist boards in considering the issues that must be addressed in establishing a capital credits policy is included in Appendix 3.

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.

Planning for capital credits retirements is a financial responsibility just like planning to repay debt, build equity and finance capital additions. An equity management plan provides the financial foundation that the board needs to balance debt and equity effectively to meet a variety of financial needs and criteria, including retiring capital credits.

The equity management plan guides the board in making decisions about rates and other issues that will allow the cooperative to generate adequate capital to fund growth and other needs without retaining member funds longer than is necessary or in amounts in excess of its needs.

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

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.

A cooperative's equity level is one of the key indicators of financial health, and maintaining an appropriate equity level is a primary goal of the equity management plan. It is also important for the cooperative network as a whole to continue to achieve a strong financial performance in order to maintain access to adequate amounts of capital at a reasonable cost. While most discussions focus on the need to maintain minimum equity levels—the Capital Credits Study Committee recommended a minimum equity level of 30 percent—it is also possible for a cooperative to create and retain excessive equity. The financial community generally equates equity in the 30 to 50 percent range with an investment-grade rating for distribution systems. The task force believes that this is an appropriate range for the equity level of most electric distribution cooperatives.

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.

Some tax advisers have suggested that cooperatives should create a pool of permanent equity that is not allocated to members as capital credits. Permanent equity may be created as a consequence of a business decision made for other reasons, such as discounting special capital credits retirements to estates. Beyond that, some cooperatives have considered adopting a goal of accruing permanent equity as a matter of policy through discounting general retirements, retaining non-patronage-sourced margins or other means.

Those who favor permanent equity say that it can provide permanent reserves, allow the co-op to rotate remaining patronage capital more quickly and improve the co-op's credit profile, among other suggested benefits. Any advantages of permanent equity, however, can be achieved more easily and with less expense through careful planning and execution of the co-op's equity management plan. Adopting a goal of creating permanent equity requires a fundamental change in the interpretation of cooperative philosophy and should be avoided.

Allocating Capital Credits

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

Depending on individual circumstances and tax status, a cooperative may or may not be legally required to notify each member of the specific amount allocated to the individual capital credits account each year.

Each member is an owner of the cooperative; each member supports the cooperative financially through the rates paid for electricity and other services; and each member is entitled to capital credits. It is consistent with cooperative principles, and common sense, that each member is entitled to know the amount of capital credits allocated each year, whether or not there is a binding legal requirement to that effect.

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.

Contractual forfeiture of capital credits is inconsistent with cooperative principles and questionable from a tax perspective. Since similar results can be achieved through other means, the practice should be avoided.

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.

Historically, the first-in, first-out (FIFO) method has been the most commonly used capital credits retirement method. The 1976 Capital Credits Study Committee recommended that cooperatives consider adopting the percentage method, citing the need to involve current members more fully in the capital credits process.

Today, the Capital Credits Task Force recognizes that the demographics of members served vary widely among electric cooperatives. Some cooperatives serve a relatively stable membership while others are experiencing a high rate of turnover. Research has shown that tenure and age affect the way members perceive the value of cooperative membership differently. The capital credits retirement method can contribute to or reduce perceptual differences.

Rather than recommend a one-size-fits-all approach, the task force suggests that each cooperative establish specific goals for capital credits retirements based on its unique member demographics, operating characteristics and legal requirements. The board should adopt a retirement method that will achieve those goals. For example, if the goal is to reward long-term patronage, the FIFO method may be the best approach. If the goal is to educate newer members in the value of the cooperative form of organization, the percentage method may be the best choice. If the cooperative wants to be sure as many members as possible receive a capital credits refund, it may prefer a hybrid method.

What is most important is that each system retires capital credits in a manner that maximizes the value to its membership.

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.

Many cooperatives make special retirements of capital credits in recognition of unusual circumstances, such as the death of a member. Some cooperatives also offer general retirements at a discount, either in order to create permanent equity or to reduce record-keeping requirements for members leaving the system.

Early retirements allow the cooperative to make a payment sooner than it otherwise would. There is a real cost to the other members of the cooperative to do that, and there is a benefit to the member to receive money sooner than the member would otherwise. It also may be unfair to some members to return investments in the cooperative to other members out of order. Discounting to reflect the time value of money is a way to balance the impact of special retirements so that no one experiences undue financial benefit or harm. Keep in mind that the Internal Revenue Service position with respect to discounts is still evolving, and discounting may result in non-member income.

The task force recognizes that special retirements are a well-established aspect of the capital credits policies of many cooperatives. Discounting those retirements preserves fairness to all members. Since the total amount of special retirements in a given year is likely to be small, the potential benefit to both the cooperative and member, for example, being able to close an estate and remove an account from the co-op's books, is likely to outweigh the potential risks.

Making general retirements at a discount is not an established practice for most systems. It is difficult to administer such a practice fairly while maintaining a strong financial performance, and it may put the cooperative at risk for failing the 85-percent test. The task force believes that cooperatives should not make general retirements at a discount. If a system wishes to do so, the task force recommends that it seek a private-letter ruling with regard to the impact on non-member income before implementing such a policy.

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.

It is important that discounted capital credits retirements be made in a fair and equitable manner. Choosing an appropriate discount rate is the key to making that happen. 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. Rather, an individual board should be able to justify and verify the rate it selects. Since rates change often, the chosen rate should be reviewed and adjusted periodically to ensure that it continues to be fair.

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

Retiring capital credits to members who reach a certain age may discriminate against other members unless a discount is applied and may become a financial burden to other members as the membership ages. If the co-op receives federal financial assistance from RUS or otherwise, the retirement may violate the Age Discrimination Act of 1975. If the co-op does not receive federal financial assistance, there does not appear to be a general prohibition against the practice. It is, however, inconsistent with cooperative principles. Likewise, depending on the outcome of current deliberations, the practice may result in capital credits being classified as a liability under FAS 150.

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.

Cooperatives have experienced many changes over time and will undoubtedly experience more changes in the future. It is impossible to anticipate what all of these changes might be, but it is possible to prepare for them by providing the board of directors with the greatest amount of flexibility possible in making future decisions. For example, FAS 150, if adopted as proposed in May 2003, would change accounting practices that have been followed for decades in a way that could have a substantial negative impact on the equity levels of systems that have mandatory provisions for the method of retiring capital credits. Adopting a more flexible approach now could help systems avoid this problem and others in the future.

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.

A co-op's capital credits policy helps the co-op operate in accordance with cooperative principles and comply with applicable state and federal laws along with the co-op's articles of incorporation and bylaws. It also provides an opportunity to connect with members in a way that builds member loyalty and educates consumers about the advantages of cooperative membership. Communicating with members about capital credits allows the cooperative to explain why the co-op is a different kind of utility and the benefits the consumer gains from being a part of the cooperative.

Appendix 1: Online Resources

Users can access the following resources online at Cooperative.com:

Announcement 96-24, Exempt Organizations, Proposed Examination Guidelines Regarding Rural Electric Cooperatives
Guidelines for Exempt Organizations Internal Revenue Agents to use during the examinations of rural electric cooperatives

Capital Credits Retirement Procedures, The Report of the Capital Credits Retirement Procedures Task Force, August 1980
Specific recommendations related to administering capital credits policies

Code of Federal Regulations 7 CFR 1767 Accounting Requirements for RUS Electric Borrowers
Uniform System of Accounts for RUS borrowers

Comments of Fitch Ratings
Summary of Fitch presentation to Capital Credits Task Force, including criteria for assessing key credit factors

Distribution Cooperative Survey Results
Summary of capital credits practices of 509 distribution cooperatives

Final Report and Recommendations, Capital Credits Study Committee, February 1976
First document to address legal, accounting and philosophical aspects of equity management, capital credits allocations and capital credits retirements in a comprehensive manner

G&T Cooperative Survey Results
Summary of capital credits practices of 30 G&T cooperatives

History of Internal Revenue Service Rulings
Washington Utility Group summary of IRS rulings related to discounting capital credits retirements

Internal Revenue Code (IRC) Section 501(c)(12)
Regulation that grants tax-exempt status to electric cooperatives, among others, and establishes criteria for tax-exemption

IRS Publication 557, Tax-Exempt Status for Your Organization
Rules and procedures for organizations that seek tax-exempt status under Section 501(c)(12)

Legal Issues Associated with Capital Credits
Extensive review of legal rights and obligations of co-ops and their patrons regarding capital credits, including citations

Michael Seto and Cheryl Chasin, *General Survey of IRC 501(c)(12) Cooperatives and Examination of Current Issues*
General cooperative principles and rules governing IRC 501(c)(12) cooperatives, the history of IRC 501(c)(12) and other requirements that affect operations of IRC 501(c)(12) cooperatives, and current issues.

Private Letter Ruling on Allocation of Multiple Services
Text of letter accepting co-op's plan to form three operating units to provide electric, gas and telecom services

Trends in Equity and Capital Credits Retirements
Discussion of trends in co-op equity and capital credits retirement levels

Update on SFAS 150
The current status of the Financial Accounting Standards Board's actions regarding proposed standard governing treatment of equity and liabilities, including capital credits

Users also can find links to the following resources on Cooperative.com:

AICPA Audit and Accounting Guide, *Audits of Agricultural Producers and Agricultural Cooperatives*
Financial reporting model and guidance on generally accepted accounting procedures

U.S. Census Data
Available data to assist with market research and demographics studies

United States Postal Service Address Management Services
USPS provides a variety of services to assist users in tracking customer address changes

Appendix 2: Frequently Asked Questions

This document is generic in nature, intended to assist board members and staff in answering basic member questions about capital credits and the co-op's capital credits policy. Individual cooperatives wishing to use these questions and answers should first modify them to reflect the specific policies of the cooperative.

What is a cooperative?
A cooperative is a business that is owned and controlled by the people who use its services.

What are capital credits?
A cooperative does not earn profits in the sense that other businesses do. Instead, any margins, or revenues remaining after all expenses have been paid, are returned to the members in proportion to their usage of the co-op's services through capital credits allocations and retirements. Capital credits represent each member's share of the cooperative's margins and ownership of the co-op.

Electric cooperatives have returned nearly $6 billion to their owners over the years and in 2003 returned more than $300 million in capital credits.

What do cooperatives do with capital credits?
Every business needs to maintain a suitable balance between debt and equity to ensure its financial health and stability. Capital credits are the most significant source of equity for most electric cooperatives. Equity is used to help meet the expenses of the co-op, such as paying for new equipment to serve members and repaying debt. Capital credits help keep rates at a competitive level by reducing the amount of funds that must be borrowed.

How does the cooperative determine who receives capital credits?
Capital credits are allocated to each member of the cooperative every year based on participation in the cooperative. The board of directors determines the basis for the allocation. Frequently, the allocations are based on such measures as the total dollar amount of services purchased or kwh of electricity consumed.

How does the cooperative notify members about capital credits allocations and retirements?
Most cooperatives notify members of annual capital credits allocations through a letter, a message on each member's bill, the co-op's Web site or other methods.

How are capital credits disbursed?
Each year the board of directors determines whether the co-op's financial position permits the return, or retirement, of capital credits and, if so, what amount of capital credits will be retired.

The board also decides the method for determining which capital credits are returned. For example, many cooperatives retire capital credits using the First-in, First-out, or FIFO, method. That means that the capital credits that have been invested in the cooperative for the longest period of time are returned to members first. A cooperative using the FIFO method might return capital credits allocated in 1984 to members in 2004.

Other co-ops retire capital credits using the percentage method. That means that a portion of the total amount of capital credits allocated to a member over time are returned each year.

Another way to retire capital credits is to use a combination of methods, such as the FIFO/Percentage hybrid, which makes part of the capital credits retirement on the FIFO basis and part using the percentage method. The Last-in, First-out, or LIFO, method, which repays capital credits that have been invested in the cooperative for the shortest period of time first, is rarely used alone, but the FIFO/LIFO hybrid is a popular approach.

The approach that works best for an individual system depends on a number of factors, including the age and tenure of its membership.

Do members receive interest on capital credits?
Some cooperatives are prohibited from paying interest on capital credits by their articles of incorporation or other legal documents. Whether that is the case, co-ops do not pay interest on capital credits, because the money to pay that interest would have to be collected from members through higher rates.

What happens to a member's capital credits if the member moves away from the system?
A member who terminates service no longer receives additional capital credits allocations. The balance in the member's capital credits account is maintained until it is retired in full.

It usually is the member's responsibility to notify the co-op of any changes in address so that the member can be located when it is time for the co-op to retire capital credits allocated to the member's account.

What happens to a member's capital credits if the member dies?
Capital credits in the member's account belong to the member's estate. In order to assist the member's heirs in closing the estate, some co-ops offer a special capital credits retirement of the outstanding balance of the deceased member's capital credits account, often at a discount.

Why are some capital credits retirements discounted?
In the interest of fairness to all members, some co-ops discount capital credits retirements, such as special retirements to estates, to reflect the net present value of making a capital credits retirement now that would otherwise be made at a later date. The smaller amount received today, if invested until the normal retirement date, would be equal to the normal retirement amount.

Why does the co-op not charge lower rates instead of retaining capital credits?
The board of directors has a fiscal responsibility to maintain the financial integrity of the cooperative in a way that provides competitive rates and allows the return of capital credits to members. Having a sound equity management plan and a commitment to serving the members are key to achieving this.

Does the member have to report capital credits on tax returns?
Capital credits are a return of money paid for electricity in a previous year and are generally not taxable income for residential consumers. Commercial and industrial consumers should discuss any capital credits retirements with their tax advisers.

Appendix 3: Capital Credits Decision Checklist

must be addressed in establishing a capital credits policy.

Board Policy on Capital Credits

- ❑ Does the cooperative have a comprehensive written capital credits policy approved by the board of directors?
- ❑ Is the policy written so that it can be easily understood by the board, management, staff, members and others?
- ❑ Does the policy include:
  - ❑ A clear, concise statement of objectives?
  - ❑ A clear, concise policy statement?
  - ❑ The board's expectations as what the policy will achieve?
  - ❑ Any limits in terms of time, process or other constraints on the implementation of the policy?
  - ❑ Direction as to responsibility for enforcement and evaluation of the policy?
- ❑ Does the policy include the date of approval, any revisions and scheduled review?
- ❑ Is the policy readily available to those who need it?
- ❑ Does the board review the policy on an annual basis?
- ❑ Does the policy clearly state the co-op's objectives regarding capital credits?
- ❑ Does the policy establish a desired equity target?
- ❑ Does the policy provide for annual review and approval of allocations and retirements by the board?

Allocating Capital Credits

- ❑ What margin components will be allocated as capital credits?
  - ❑ Patronage-source income only (operating margins and other income as determined by tax regulations)
  - ❑ All income, including patronage-sourced and non-patronage-sourced income
- ❑ Will the co-op make separate allocations for some patronage-sourced margins?
  - ❑ Capital credit allocations received from a G&T
  - ❑ Capital credit allocations received from other affiliated organizations
  - ❑ Other (specify) ________________________
- ❑ Will the co-op allocate margins to customers in different classes based on the contribution of each class to the co-op's margins?
- ❑ On what basis will margins be allocated?
  - ❑ Dollar amount of services purchased
  - ❑ Quantity of kwh purchased
  - ❑ Dollar contribution to margin
  - ❑ Other (specify) ________________________
- ❑ For cooperatives offering multiple services, is the co-op required to allocate margins from

these services separately?
- ❑ If so, is the cooperative in compliance with this requirement?

❑ How will the co-op notify members of the amount of capital credits allocations each year?
- ❑ U.S. mail
- ❑ Message on bill
- ❑ Electronically through online bill payment
- ❑ Combination of methods (specify) ______________________
- ❑ Other (specify)________________________

Retiring Capital Credits

❑ What amount of capital credits will the co-op retire this year?
- ❑ What level of capital credits retirements is supported by the co-op's equity management plan and financial forecast?
- ❑ Is the co-op's financial performance adequate to retire capital credits?

❑ What retirement method will the co-op use?
- ❑ What are the co-op's objectives for maximizing the value of capital credits retirements?
- ❑ What is the age distribution of the co-op's members?
- ❑ What is the tenure of the co-op's members?
- ❑ What are the members' expectations regarding capital credits retirements?
- ❑ What percentage of current members will receive a capital credits retirement?
- ❑ Which retirement method best meets the co-op's objectives for maximizing the value of capital credits retirements?
  - ❑ First-in, First-out (FIFO)
  - ❑ Percentage of total allocated capital credits
  - ❑ Hybrid of FIFO and percentage method
  - ❑ Hybrid of FIFO and Last-in, First-out (LIFO) method
  - ❑ Other (specify)________________________

❑ Should the cooperative make special capital credits retirements?
- ❑ What are the objectives of the special retirement?
- ❑ Accommodate the estates of deceased members?
- ❑ Other (specify)________________________

❑ Should the co-op discount special capital credits retirements?
- ❑ Should discounted capital credits retirements be voluntary or mandatory?
- ❑ What discount rate should the co-op use?

Maximizing the Value of Capital Credits Retirements

- ❑ What payment method for capital credits retirements provides the greatest value, considering the costs and benefits?
  - ❑ Check
  - ❑ Bill credit
  - ❑ Should the co-op set a minimum amount for retirement by check?
- ❑ What is the best time to issue capital credits refunds?
  - ❑ Around the holidays
  - ❑ At the end of the school year
  - ❑ At the annual meeting
  - ❑ During the peak season for utility bills
  - ❑ Other (specify)________________________
- ❑ What is the co-op's plan for educating members about capital credits and the co-op's capital credits policies?
  - ❑ Can all of the co-op's board members explain the co-op's capital credits policy and answer specific questions from consumers?
  - ❑ Can all of the co-op's employees explain the co-op's capital credits policy and answer specific questions from consumers?
  - ❑ Does the co-op present information about capital credits on its Web site and in its newsletter or other publications?
- ❑ How can the co-op use unclaimed capital credits to enhance the perception of the co-op and contribute to the community?

Compliance Issues

- ❑ Is the co-op in compliance with the requirements of applicable authorities governing capital credits retirements?
  - ❑ Federal laws
  - ❑ State laws
  - ❑ Articles of incorporation
  - ❑ Mortgage covenants
  - ❑ Bylaws
- ❑ Is the co-op in compliance with applicable accounting standards?
- ❑ Are the cooperative's current practices in compliance with its capital credits policy?

Appendix 4: Sample Bylaws

The following sample electric cooperative capital credits bylaws address the allocation, notification, assignment, and retirement of capital credits. They do not address other bylaws impacting or involving capital credits, like bylaws governing dissolution, etc.

These sample bylaws are a guide and resource to assist electric cooperatives in adopting or amending capital credits bylaws. ***They are not "model" bylaws to be adopted without extensive review, consideration, and revision.***

These sample bylaws are based upon federal cooperative tax law and general state cooperative law. They are not based upon the law of any particular state. These sample bylaws are drafted primarily for an electric distribution cooperative that is exempt from federal income taxation, with some flexibility for fiscal years during which the cooperative becomes nonexempt, or taxable. ***Before considering, adopting, or amending capital credits bylaws, an electric cooperative should consult with its attorney and tax consultant.***

Because state laws vary, and because electric cooperatives may reach different policy decisions and have different tax considerations, these sample bylaws include alternative or optional language that is *[italicized and bracketed]*. As used in these sample bylaws, "Cooperative" means the electric cooperative and "Board" means the electric cooperative's board of directors or trustees.

SAMPLE CAPITAL CREDITS BYLAW

Section X.XX – Allocation of Capital Credits. The term "patron" means, during a fiscal year: (1) a member of the Cooperative and (2) any other individual or entity purchasing a good or service from the Cooperative to whom the Cooperative is obligated to allocate capital credits, which obligation existed before the Cooperative received payment for the good or service.[1]

For each good or service provided by the Cooperative on a cooperative basis during a fiscal year, the Cooperative shall equitably allocate to each patron, in proportion to the quantity or value of the good or service purchased by the patron during the fiscal year,[2] the Cooperative's patronage earnings from providing the good or service during the fiscal year, which is the amount by which the Cooperative's patronage sourced revenues from providing the good or service exceed the Cooperative's patronage sourced expenses[3] of providing the good or service, all as determined under federal cooperative tax law.[4] If the Cooperative's patronage sourced expenses of providing the good or service during the fiscal year exceed the Cooperative's patronage sourced revenues from providing the good or service during the fiscal year, all as determined under federal cooperative tax law, then the Cooperative shall: (1) allocate this patronage loss to each patron in proportion to the quantity or value of the good or service purchased by the patron during the fiscal year;[5] (2) offset this patronage loss with the Cooperative's patronage earnings from providing the good or service during the most recent past fiscal year(s) or the next succeeding future fiscal year(s); or (3) offset this patronage loss first with the Cooperative's nonpatronage earnings during the current fiscal year, second with the Cooperative's unallocated nonpatronage earnings during any past fiscal year(s), and third with the Cooperative's nonpatronage earnings during any future fiscal year(s).

[1] This definition of "patron" is based upon federal cooperative tax law. Through contract or otherwise, a non-member customer may be legally entitled to an allocation of capital credits.
[2] As allowed by state cooperative law, an electric cooperative may revise this and similar clauses to add the following italicized language to read: "in proportion to the quantity or value of the good or service purchased by the patron during the fiscal year *and timely paid for* by the patron."
[3] As allowed by state cooperative law, and consistent with federal cooperative tax law, an electric cooperative may further define the "expenses" referenced in these sample bylaws.
[4] Patronage earnings generally include all operating income. They also include some nonoperating income, like interest earned on reasonable amounts of working capital and possibly the gain on the sale of capital assets. Under federal cooperative tax law, an exempt electric cooperative is obligated to allocate operating margins only, instead of all patronage earnings. Under federal cooperative tax law, other exempt cooperatives, as well as nonexempt cooperatives, are obligated or encouraged to allocate all patronage earnings, instead of operating margins only. For consistency and simplicity, and to mitigate the adverse tax consequences of an electric cooperative temporarily or permanently losing its exemption, these sample bylaws require the allocation of all patronage earnings, instead of operating margins only. An exempt electric cooperative, however, may choose to require the allocation of operating margins only, instead of all patronage earnings.
[5] The Rural Utilities Service prohibits distribution borrowers from allocating operating losses.

[For each fiscal year, the Cooperative shall equitably allocate to each patron, in proportion to the quantity or value of goods or services purchased by the patron during the fiscal year, the Cooperative's nonpatronage earnings, which is the amount by which the Cooperative's nonpatronage sourced revenues during the fiscal year exceed the Cooperative's nonpatronage sourced expenses during the fiscal year, less any amount needed to offset a patronage loss. OR As determined by the Board, the Cooperative may use, retain, or equitably allocate the Cooperative's nonpatronage earnings, which is the amount by which the Cooperative's nonpatronage sourced revenues during a fiscal year exceed the Cooperative's nonpatronage sourced expenses during the fiscal year, less any amount needed to offset a patronage loss.[6]] [If the Cooperative's nonpatronage sourced expenses during the fiscal year exceed the Cooperative's nonpatronage sourced revenues during the fiscal year, then the Cooperative shall allocate this nonpatronage loss to each patron in proportion to the quantity or value of goods or services purchased by the patron during the fiscal year or offset this nonpatronage loss with the Cooperative's nonpatronage earnings during any fiscal year.]

For each amount allocated to a patron, the patron shall contribute a corresponding amount to the Cooperative as capital. The Cooperative shall credit all capital contributions from a patron to a capital account for the patron. The Cooperative shall maintain books and records reflecting the capital contributed by each patron. At the time of receipt by the Cooperative, each capital contribution will be treated as though the Cooperative paid the allocated amount to the patron in cash pursuant to a pre-existing legal obligation and the patron contributed the corresponding amount to the Cooperative as capital. The term "capital credits" means the amounts allocated to a patron and contributed by the patron to the Cooperative as capital.

Consistent with this bylaw, the allocation of capital credits is in the discretion of the Board and the Board shall determine the manner, method, and timing of allocating capital credits. As reasonable and fair, the Cooperative may allocate capital credits to classes of similarly situated patrons under different manners, methods, and timing, provided the Cooperative allocates capital credits to similarly situated patrons under the same manner, method, and timing. The Cooperative may use or invest unretired capital credits as determined by the Board.

If the Cooperative is a member, patron, or owner of an entity from which the Cooperative purchases a good or service used by the Cooperative in providing a good or service and from which the Cooperative is allocated a capital credits or similar amount, then, as determined by the Board and consistent with this bylaw, the Cooperative may separately identify and allocate to the Cooperative's patrons this capital credits or similar amount allocated by the entity.

Upon the Cooperative receiving written notice and sufficient proof of the death of a spouse in a joint membership, the Cooperative shall assign and transfer to the surviving spouse the capital credits allocated, or to be allocated, to the joint membership. Upon the Cooperative receiving written notice and sufficient proof of the dissolution of marriage between spouses in a joint membership, and unless otherwise instructed by a court or administrative body of competent jurisdiction, the Cooperative shall assign and transfer to each spouse one-half (1/2) of the capital credits allocated to the joint membership.[7]

[To secure a patron's obligation to pay all amounts owed to the Cooperative, including any compounded interest and late payment fee, and in return for the Cooperative providing a good or service to the patron, the Cooperative has a security interest in capital credits allocated to the patron. The patron authorizes the Cooperative to perfect this security interest by filing a financing statement.[8]]

[6] State cooperative law may require a cooperative to allocate nonpatronage earnings. Federal cooperative tax law, however, does not require a cooperative to allocate nonpatronage earnings.

[7] If state law and an electric cooperative's bylaws permit a joint membership comprised of individuals other than spouses, then the cooperative must revise this bylaw accordingly.

[8] To be enforceable, a patron must usually sign or otherwise authenticate this security interest. To best protect and prioritize this security interest, an electric cooperative should perfect it, usually by filing a financing statement. State law usually includes detailed provisions governing the creation, enforcement, and perfection of security interests.

Section X.XX – Notification and Assignment of Capital Credits. Within a reasonable time following the end of each fiscal year, the Cooperative *[shall OR may]* notify each patron in writing of the stated dollar amount of capital credits allocated to the patron for the preceding fiscal year.[9] Unless the Board determines otherwise, and unless these bylaws provide otherwise, the Cooperative may assign or transfer a patron's capital credits only if: (1) the Cooperative receives a written request signed by the patron to assign or transfer the capital credits, (2) the patron and the assignee or transferee comply with all reasonable requirements specified by the Cooperative, and (3) the Board approves the assignment or transfer.

Section X.XX – Retirement of Capital Credits. At any time before the Cooperative's dissolution, liquidation, or other cessation of existence, the Cooperative may generally retire and pay some or all capital credits allocated to patrons and former patrons.

Upon the death of an individual patron or former patron, upon receiving a written request from the deceased individual's legal representative, and under terms and conditions agreed upon by the Cooperative and the deceased individual's legal representative, the Cooperative may specially retire some or all capital credits allocated to the individual. *[Upon the dissolution, liquidation, or other cessation of existence of an entity patron or former patron, upon receiving a written request from the former entity's legal representative, and under terms and conditions agreed upon by the Cooperative and the former entity's legal representative, the Cooperative may specially retire and pay some or all capital credits allocated to the former entity. OR Upon the dissolution, liquidation, or other cessation of existence of an entity patron or former patron, the Cooperative may not specially retire and pay capital credits allocated to the former entity.] [Upon the reorganization, merger, or consolidation of an entity patron or former patron, upon receiving a written request from the entity or the entity's legal representative, and under terms and conditions agreed upon by the Cooperative and the entity or the entity's legal representative, the Cooperative may specially retire and pay some or all capital credits allocated to the entity. OR Upon the reorganization, merger, or consolidation of an entity patron or former patron, the Cooperative may not specially retire and pay capital credits allocated to the entity.]*

If the Cooperative separately identified and allocated capital credits representing capital credits or similar amounts allocated to the Cooperative by an entity in which the Cooperative is or was a member, patron, or owner, then the Cooperative shall retire and pay these capital credits *[before or after OR after]* the entity retires and pays the capital credits or similar amounts to the Cooperative.

After retiring capital credits allocated to a patron or former patron, the Cooperative may recoup, offset, or setoff any amount owed to the Cooperative by the patron or former patron, including any compounded interest and late payment fee, by reducing the amount of retired capital credits paid to the patron or former patron by the amount owed.

The Cooperative may retire and pay capital credits only if the Board determines that the retirement and payment will not adversely impact the Cooperative's financial condition. Consistent with this bylaw, the retirement and payment of capital credits are in the discretion of the Board and the Board shall determine the manner, method, and timing of retiring and paying capital credits. As reasonable and fair, the Cooperative may retire and pay capital credits to classes of similarly situated patrons under different manners, methods, and timing, provided the Cooperative retires and pays capital credits to similarly situated patrons under the same manner, method, and timing. *[As determined by the Board, before the time the Cooperative anticipates normally retiring and paying capital credits, the Cooperative may retire some or all capital credits and pay the net present value of the retired capital credits. OR As agreed upon by the Cooperative and a patron or former patron, before the time the Cooperative anticipates normally retiring and paying capital credits allocated to the patron or former patron, the Cooperative may retire some or all of the capital credits and pay the net present value of the retired capital credits.]*

[9] Federal cooperative tax law does not require an exempt electric cooperative to notify patrons of annual capital credits allocations. A nonexempt electric cooperative may exclude or deduct from its taxable income capital credits allocated to a patron, but only if the cooperative provides the patron written notice of the stated dollar amount of the allocation within 8 1/2 months after the end of a fiscal year. Accordingly, if the Internal Revenue Service audits an exempt electric cooperative and determines that the cooperative was unintentionally nonexempt during an earlier year, then the cooperative must have provided this written notice in order to exclude or deduct allocated capital credits from its taxable income.

The Cooperative may regularly impose a reasonable dormancy or service charge for each *[month OR year]* a patron or former patron fails to claim capital credits retired and paid to the patron or former patron. *[Through a voluntary written assignment signed by a patron or former patron, which assignment is revocable and is not a condition of the Cooperative providing a good or service to the patron, the patron or former patron may assign or transfer to the Cooperative any past, present, or future capital credits retired and paid to the patron or former patron, but not claimed by the patron or former patron within __________ (__) years of retirement and payment, provided the Cooperative undertook or undertakes reasonable measures to notify the patron or former patron of the retired and paid capital credits.]*

Appendix 5: Sample Board Policy

This "Sample Electric Cooperative Capital Credit Policy" is based upon general state cooperative law and federal cooperative tax law. It is not based upon the law of any particular state. In addition, this policy incorporates recommendations by the Capital Credits Task Force, as well as capital credits philosophical considerations discussed during task force meetings. This policy is primarily for an electric distribution cooperative that is exempt from federal income taxation, with flexibility for years during which the cooperative intentionally or unintentionally becomes nonexempt, or taxable.

Because state laws vary, and because electric cooperatives may reach different capital credits philosophical decisions and have different tax considerations, each cooperative should individually review and revise this policy to comply with its unique needs, desires, and requirements. This is not a "model" policy to be adopted without extensive review, consideration, and discussion. ***Before considering, adopting, or revising a capital credits policy, an electric cooperative should consult with its attorney and tax consultant.***

SAMPLE BOARD POLICY

Capital Credits Policy of ____________________
Adopted __________

I. Objective.

The objective of this Capital Credits Policy ("Policy") is to state the general policy of ____________________ ("Cooperative") for allocating and retiring capital credits.

II. Policy.

The Cooperative shall allocate and retire capital credits in a manner that: (1) is consistent with state and federal law; (2) is consistent with operating on a cooperative basis under federal tax law; (3) is fair and reasonable to the Cooperative's patrons and former patrons; (4) provides the Cooperative with sufficient equity and capital to operate effectively and efficiently; and (5) protects the Cooperative's financial condition. Subject to law, the Cooperative's articles of incorporation, and the Cooperative's bylaws, the allocation and retirement of capital credits are at the sole discretion of the Cooperative's Board of Directors ("Board").

III. Expectations.

A. **Board Approval.** The Cooperative shall allocate and retire capital credits according to the manner, method, timing, and amount approved by the Board.

B. **Patronage Earning Allocations.** For each good or service provided by the Cooperative on a cooperative basis during a fiscal year, the Cooperative shall equitably allocate to each patron, in proportion to the value of the good or service purchased by the patron during the fiscal year, the Cooperative's patronage earnings from providing the good or service during the fiscal year.

C. **Patronage Loss Allocations.** For each good or service provided by the Cooperative on a cooperative basis, the Cooperative shall offset patronage losses with the Cooperative's patronage earnings from providing the good or service during the next succeeding future fiscal year(s).

D. **Nonpatronage Earning Allocations.** As approved by the Board, the Cooperative may use, retain, or equitably allocate the Cooperative's nonpatronage earnings.

E. **Nonpatronage Loss Allocations.** The Cooperative shall offset nonpatronage losses with the Cooperative's nonpatronage earnings during any fiscal year.

F. **General Capital Credits Retirements.** The Cooperative shall generally retire capital credits with the goals of: (1) maintaining an equity level between __________ percent (_____ %) and __________ percent (_____ %) of the Cooperative's total assets; (2) retiring some capital credits every year during the month(s) of __________; (3) retiring capital credits on a ________________________________ basis; (4) retiring capital credits within __________ (_____) years after their allocation; (5) communicating and promoting the cooperative principles; (6) fostering loyalty and support among patrons and former patrons; and (7) maximizing public relations and political goodwill.

G. **Special Capital Credits Retirements.** The Cooperative: (1) may specially retire capital credits upon the death of an individual patron or former patron; (2) may not specially retire capital credits upon the dissolution, liquidation, or cessation of existence of an entity patron or former patron; (3) may not specially retire capital credits upon the reorganization, merger, or consolidation of an entity patron or former patron; (4) may not specially retire capital credits upon a patron or former patron reaching a certain age; (5) may not specially retire capital credits upon a patron becoming a former patron; (6) may not specially retire capital credits upon a patron failing to pay an amount owed to the Cooperative within __________ (_____) days of the date payment was due; and (7) may specially retire capital credits upon a former patron failing to pay an amount owed to the Cooperative within __________ (_____) days of the date payment was due.

H. **Discounted General Capital Credits Retirements.** The Cooperative may not generally retire capital credits before the time the Cooperative anticipates normally retiring the capital credits and pay the discounted, net present value of the capital credits.

I. **Discounted Special Capital Credits Retirements.** For capital credits specially retired before the time the Cooperative anticipated normally retiring the capital credits, as agreed upon by the Cooperative and a patron or former patron, the Cooperative may pay the discounted, net present value of the capital credits.

J. **Recoupment.** After retiring, and before paying, capital credits allocated to a patron or former patron, the Cooperative may recoup, offset, or setoff any amount owed to the Cooperative by the patron or former patron by reducing the amount of retired capital credits paid to the patron or former patron by the amount owed.

IV. Limitations.

A. **Forfeiture of Capital Credits.** The Cooperative shall not enter contracts through which a patron or former patron forfeits the right to the allocation or retirement of capital credits. The Cooperative shall not require any patron or former patron to forfeit the right to the allocation or retirement of capital credits.

B. **Patron Classes.** As reasonable and fair, and as approved by the Board, the Cooperative may allocate or retire capital credits to classes of similarly situated patrons or former patrons under different manners, methods, timing, and amounts, provided the Cooperative allocates and retires capital credits to similarly situated patrons and former patrons under the same manner, method, timing, and amount.

C. **Separate Allocations and Retirements.** The Cooperative shall separately identify and allocate to the Cooperative's patrons capital credits and similar amounts allocated to the Cooperative by an entity in which the Cooperative is a member, patron, or owner. The Cooperative may retire these separately identified and allocated capital credits only after the entity retires and pays the amounts to the Cooperative.

D. Notice of Allocation. Within eight and one-half (8 1/2) months following a fiscal year, the Cooperative shall notify each patron in writing of the amount of capital credits allocated to the patron for the preceding fiscal year through a written notice stating the dollar amount allocated.

E. Adverse Financial Impact. The Cooperative shall not retire any capital credits unless the Board first determines that the retirement will not adversely impact the Cooperative's financial condition.

F. Request and Agreement for Special Retirement. The Cooperative may specially retire capital credits upon the death of a patron or former patron only upon receiving a written request from the appropriate legal representative, and only under terms and conditions agreed upon by the Cooperative and the appropriate legal representative.

G. Discount Rate. If the Cooperative retires capital credits before the time the Cooperative anticipates normally retiring the capital credits and pays the discounted, net present value of the capital credits, then the Cooperative shall use a discount rate equaling the Cooperative's weighted cost of capital.

H. Minimum Amount. The Cooperative shall not retire and pay capital credits in an amount less than five dollars ($ 5.00), unless the retirement and payment is for all remaining capital credits allocated to a former patron.

I. Payment and Notice of Retirement. After the Cooperative retires capital credits allocated to a patron, the Cooperative shall pay the retired amount by sending a check for the amount to the patron's most current address listed on the Cooperative's records. After the Cooperative retires capital credits allocated to a former patron, the Cooperative shall pay the retired amount by sending a check for the amount to the former patron's most current address listed on the Cooperative's records.

J. Unclaimed Capital Credits. If a patron or former patron fails to claim a retired capital credits amount within __________ (_____) days, then the Cooperative shall send a notice regarding the failure to the patron or former patron's most current address listed on the Cooperative's records. If the patron or former patron fails to claim the retired amount within __________ (_____) days after the notice, then, for each year the patron or former patron fails to claim the retired amount, the Cooperative may impose a dormancy or service charge equaling __________ dollars ($ _____). If a patron or former patron fails to claim the retired amount within __________ (_____) years, then the Cooperative shall provide any notice and take any other action required by law, and may use the amount as permitted by law.

V. Responsibility.

A. Implementation of Policy. The Cooperative's general manager or chief executive officer ("Manager") is responsible for implementing this Policy and for developing the practices and procedures necessary to allocate and retire capital credits according to this Policy.

B. Recommendations to Board. The Cooperative's Manager is responsible for: (1) recommending to the Board the manner, method, timing, and amount for allocating and retiring capital credits; and (2) when in the best interest of the Cooperative and its patrons and former patrons, recommending to the Board revisions to this Policy.

C. Review and Approval by Board. The Board is responsible for: (1) reviewing, discussing, and evaluating the Manager's recommendations regarding the manner, method, timing, and amount for allocating and retiring capital credits; (2) approving the manner, method, timing, and amount for allocating and retiring capital credits; (3) reviewing, discussing, and evaluating this Policy every year; (4) reviewing, discussing, and evaluating the Manager's recommendations for revising this Policy; and (5) revising this Policy.

D. Compliance with Policy. The Board is responsible for the Cooperative's compliance with this Policy.

Appendix 6: Equity Management Theory

Revisiting Equity Management—The Art of Wise Compromise
Claudia Phillips, Vice President of Programs and Planning Analysis, CFC

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Background

The rural electric program had its beginnings in Franklin Roosevelt's first term as president in the 1930s. It was simultaneously an effort to bring electricity to the rural areas and create jobs in the 48 states then building the electric lines, wiring houses and operating the newly created electric systems.

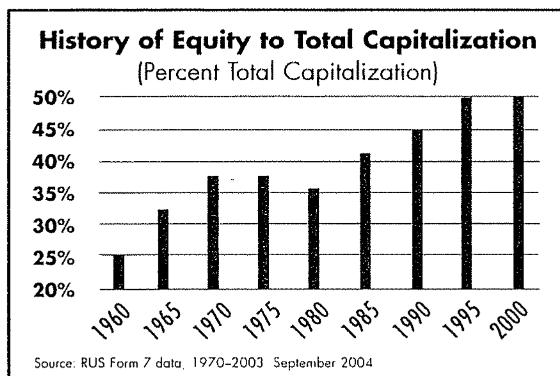
In most of the areas where the rural electrification program was established to provide electric service, the existing investor-owned utility companies exhibited little interest in making the necessary investments to serve the rural areas on an area-coverage basis. In their opinion, there would never be sufficient demand for electric service to provide the rate of return they deemed necessary to justify the investment.

In order for many projects to show feasibility, most Rural Electric Administration (REA) borrowers were established as non-profit cooperative corporations. In most states, enabling legislation had to be enacted to provide a framework under which these non-profit cooperative corporations could be created. As of December 31, 2000, most CFC and RUS (formerly REA) distribution borrowers are electric cooperatives with a relatively small group of public power districts (Nebraska) or public utility districts (Washington and Oregon).

These projects were feasible only with the combined advantages of long-term, low-interest REA loans for 100 percent of the project cost, exemption from federal income taxes because of their non-profit cooperative status, standardization of accounting, reporting, construction, etc. and a wealth of technical assistance from REA.

Most, if not all REA borrowers, were incorporated with an equity, which consisted only of a $5 per consumer "membership fee" that was consumed largely by the organizational expenses of the fledgling businesses.

The Need for Margins and Equity



From the beginning, RUS recommended that its borrowers earn margins to build reserves against contingencies and to provide the rural electric cooperative members with some equity in the system that they "owned" but which was mortgaged to the federal government. It was evident in both policy and mortgage documents that a 40 percent equity level was desirable.

A capital credits allocation and refunding plan evolved that provided the rationale for a non-profit corporation charging rates for service in excess of the cost of providing service and "allocating" the "margins" back to the member-owners in proportion to their patronage. Provision was made to refund or revolve these allocated credits back to the members when cooperative boards of directors deemed that the financial condition of the cooperative justified the capital credits refund.

Since that time, the composite equity of the rural electric distribution program has grown to 47 percent of total capitalization.

The Importance of Adequate Earnings Ratios

During the 1970s, when the federal government was faced with the situation that the growing capital requirements of the program far exceeded amounts they were willing to authorize, CFC was created by program leaders as a vehicle to attract capital in the private capital market. Today, with loans and guarantees outstanding to members of approximately $22 billion, CFC continues to meet these needs.

As a private lender, CFC plays a significant role in educating the financial community about the financial health of its rural electric cooperative members. In fact, in connection with its first Collateral Trust Bond issue, CFC made potential investors aware of the rural electric program's outstanding composite earnings track record. During the decade preceding the sale of these collateral trust bonds, the composite earnings ratio of all rural electric distribution systems was within the 3.23 to 3.73 range, with the trend being upward with time. These consistently strong ratio achievements have contributed to CFC's ability to earn solid bond ratings from S&P and Moody's from its early years to today.

Since CFC's credit is a reflection of the creditworthiness of its member systems, its ability to sell long-term bonds at favorable interest rates is in large part a function of each member-distribution system maintaining adequate earnings ratios and equity levels.

Next Stage in the Life Cycle

The jump from meeting federal government requirements to meeting Wall Street's requirements to attract additional sources of debt capital on the open market required consistent maintenance of acceptable terms such as coverage and equity.

> **As part of this effort, CFC and NRECA created the Capital Credits Study Committee in 1976. The committee's charter was to study all aspects of the ideas, work and methods from various individuals and groups in the rural electric program, and develop and promulgate concepts regarding margins, equity levels and, ultimately, revenue requirements.**

Regulatory commissions accepted the premise that investor-owned utilities must be allowed a rate of return sufficient to cover the interest on their outstanding long-term debt and to provide a reasonable return on the equity capital invested by the owners or stockholders. Soon cooperative leaders rapidly embraced the same philosophy.

Equity Management Planning

Mathematical models were developed, and later improved, that contained principal concepts indicating that there was an "optimum" equity level for every cooperative. This optimum level being a function of each system's blended cost of debt capital, its capital credits revolving cycle, its rate of growth in total capitalization, and its TIER (Times Interest Earned Ratio) objective. The models were able to prove that if a system's actual equity level were either higher or lower than the optimum level, higher electric rates would be needed in order to provide sufficient revenues to satisfy all of the constraints operating to restrict the cooperative's freedom of action.

James Goodwin, formerly with the REA, is credited with some of the first work in equity management for rural electric cooperatives. Goodwin developed a formula, that was later modified, that produced a percentage return on equity (Re) that is still used today in equity management planning.

The modified Goodwin formula is as follows:

$$Re = \frac{(1 + g)^{n+1} - (1 + g)^{n}}{(1 + g)^{n} - 1} \times \text{"100"}$$

Where Re = Rate of Return on Equity (as a percentage)
g = Rate of Growth in Total Capitalization
n = Period of Capital Credit Rotation (in years)

The formula produces the rate of return on equity to be earned each year on the total equity as of December 31 of the prior year in order to hold equity at its present level.

A table for values of Re for varying growth rates and varying periods of patronage capital rotation follows:

Return On Equity %

Annual Rate of Growth	Period of Revolving Capital Credits (Years) 10	15	16	17	18	19	20	1000 (Infinity)
0.00	10.00	6.67	6.25	5.88	5.56	5.26	5.00	0.00
1.00	10.56	7.21	6.79	6.43	6.10	5.81	5.54	1.00
2.00	11.13	7.78	7.37	7.00	6.67	6.38	6.12	2.00
3.00	11.71	8.38	7.96	7.60	7.27	6.98	6.72	3.00
4.00	12.33	8.99	8.58	8.22	7.90	7.61	7.36	4.00
5.00	12.95	9.63	9.23	8.87	8.55	8.27	8.02	5.00
6.00	13.59	10.29	9.90	9.54	9.24	8.96	8.72	6.00
7.00	14.24	10.98	10.59	10.24	9.94	9.68	9.44	7.00
8.00	14.90	11.68	11.30	10.96	10.67	10.41	10.19	8.00
9.00	15.58	12.41	12.03	11.70	11.42	11.17	10.95	9.00
10.00	16.27	13.15	12.78	12.47	12.19	11.95	11.75	10.00
11.00	16.98	13.91	13.55	13.25	12.98	12.76	12.56	11.00
12.00	17.70	14.68	14.34	14.05	13.79	13.58	13.39	12.00
13.00	18.43	15.47	15.14	14.86	14.62	14.41	14.24	13.00
14.00	19.17	16.28	15.96	15.69	15.46	15.27	15.10	14.00
15.00	19.93	17.10	16.79	16.54	16.32	16.13	15.98	15.00
16.00	20.69	17.94	17.64	17.40	17.19	17.01	16.87	16.00
17.00	21.47	18.78	18.50	18.27	18.07	17.91	17.77	17.00
18.00	22.25	19.64	19.37	19.15	18.96	18.81	18.68	18.00
19.00	23.05	20.51	20.25	20.04	19.87	19.72	19.60	19.00
20.00	23.85	21.39	21.14	20.94	20.78	20.65	20.54	20.00

Using the Return on Equity chart to demonstrate, a system growing at 6 percent per year in total capitalization and revolving capital credits on a 20-year cycle would require an Re of 8.72 percent to maintain its present equity position. If a lower Re were earned, the percentage equity would fall. If a higher Re were earned, the percentage equity would increase. If a longer revolving cycle were used, a lower Re would be adequate. If a shorter cycle were used, a higher Re would be necessary. If there were no capital credits refunds (with a cycle of infinity years represented in the chart as "1000"), the Re would be the system's rate of growth in that year.

The second component of total capitalization is debt capital, or long-term debt. Technically, the blended cost of a system's long-term debt would be calculated by multiplying the outstanding balance on each long-term note by the interest rate on that note, summing the interest amounts together, summing the note balances together, and dividing the total interest by the total of the outstanding note balances. For convenience, an approximation of the blended interest could be determined by dividing the total interest paid (on long-term debt) by the average of the total debt outstanding for the last full year and prior year.

$$\frac{\text{Interest} \quad \$470{,}000}{\text{Principal} \quad (7{,}500{,}000 + \$8{,}166{,}666)/2} = 6.0\% \text{ Cost of Debt}$$

It is important to be aware that the rate of change in the cost of debt can be influenced by many factors including:

- How fast new higher cost debt is requisitioned
- A system's rate of growth in plant
- The amount of internally generated funds invested in plant
- The amount refunded in capital credits each year
- How fast the older, low interest loans are amortized

The primary purpose of running a financially sound business in a financially sound manner is to ensure the availability of credit that will provide capital funds whenever debt capital is needed. While many factors enter into the ratings of credit risk and debt quality, the most commonly noted factor is interest coverage or TIER. By combining the criteria for patronage capital (as related to return on equity) with reasonable coverage criteria on interest charges (at what may be deemed a desirable capital structure) a valid indicator of the cooperative's financial health can be produced at minimal costs.

Putting the Pieces Together

Now, lets look at the total rates of return for a system having a 6 percent rate of growth (in TC), rotating capital credits on a 20-year cycle, and having a blended interest cost of 6 percent at various equity positions:

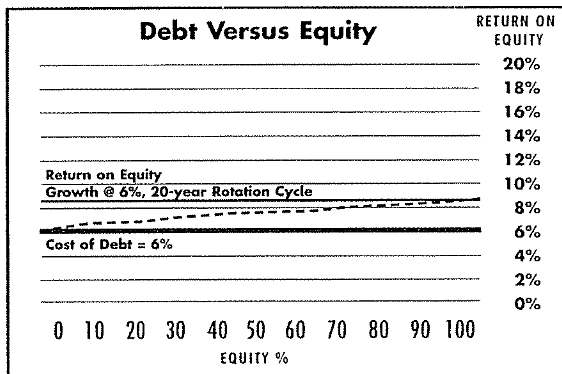
Equity Position	20%	40%	60%	80%
Equity @ 8.72%	1.74	3.49	5.23	6.98
Debt @ 6.00%	4.80	3.60	2.40	1.20
Total Rate of Return	6.54%	7.09%	7.63%	8.18%
TIER = $\frac{\text{Re + Interest}}{\text{Interest}}$	1.36	1.97	3.18	6.82

When the constant equity return prevailed, there was insufficient interest coverage at the lower equity position and excess coverage at the higher equity position.

Next, let's look at the same system, with the same rates, with our constant criteria now being interest coverage, or TIER, of 3.0:

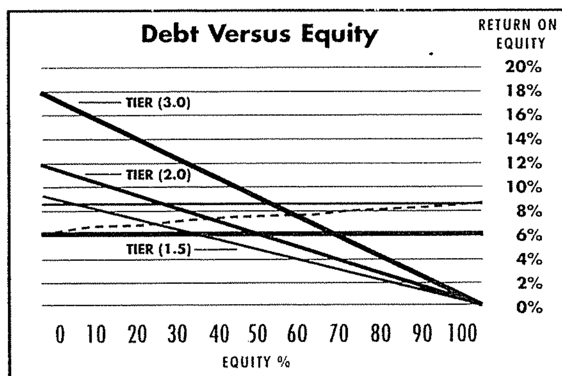
Equity Position	20%	40%	60%	80%
Equity Re Required	9.60	7.20	4.80	2.40
Interest	4.80	3.60	2.40	1.20
Total Rate of Return	14.40%	10.80%	7.20%	3.60%
TIER = (Re + Interest) / Interest	3.0	3.0	3.0	3.0

With a constant TIER goal, there is excessive return on equity at the lower equity positions and insufficient return on equity at the higher equity positions. It is obviously not prudent to operate at either extreme.



The graph at left provides a visual analysis of alternative approaches. Operating at 100 percent debt at 6 percent interest would be the cheapest alternative for the cooperative. Operating at 100 percent equity with a 20-year capital credits revolving cycle that results in an 8.72 percent return requirement would be the most expensive alternative. The diagonal line connecting the two denotes the blended cost alternatives of the debt and equity components to the cooperative.

As a practical matter, however, virtually every cooperative operates using a mixture of debt and equity. Mortgage provisions of RUS and CFC set TIER at minimum levels of 1.25 to 1.50 to ensure debt and interest payment coverage. These targets are not expected to provide the necessary margins to operate the business, maintain equity and retire capital credits on a consistent cycle. Most cooperatives will find they need to operate at a TIER level of between 2.0 and 3.0 to generate sufficient margins and cash flows to carry out the goals and objectives established by their cooperative's board of directors.

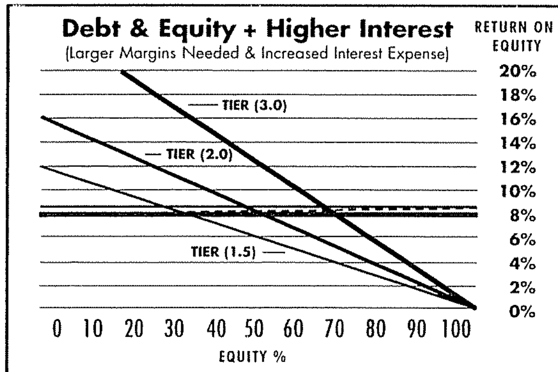


The example at left illustrates that, given the costs of debt and equity, a 2.0 TIER would support an equity level of 41 percent and a 3.0 TIER would support an equity level of 57 percent.

If interest costs were to rise to 8 percent, with everything else remaining the same, the resulting TIER level would drop. Larger margins would be needed, as the increased interest expense would drive up margin levels even though there is a lower TIER requirement.

If the cooperative chooses to maintain a 2.0 TIER, the resulting equity level would grow to 48 percent. A 3.0 TIER target would support an equity level of 64 percent.

If we assume that debt costs remain at 6 percent but equity costs increased as a result of growth to 8 percent and the capital credits revolving cycle remained on a 20-year cycle, our cost of equity rises to 10.19 percent. In the prior example the cooperative was able to maintain equity at 48 percent with a TIER of 2.0. Under this scenario, if the cooperative operates at a 2.0 TIER, the resulting equity level can be supported only to 38 percent. At a 3.0 TIER, equity would fall to 54 percent from the previous 57 percent. It is easy to see how the increases in debt and equity costs cause changes in TIER requirements.



Debt & Equity + Higher Equity Cost
(Higher TIER Needed to Support Same Equity Level)

RETURN ON EQUITY: 20% 18% 16% 14% 12% 10% 8% 6% 4% 2% 0%

TIER (3.0) · TIER (2.0) · TIER (1.5)

0 10 20 30 40 50 60 70 80 90 100

EQUITY %

The Art of Wise Compromise

Equity management concepts and models continue to remain a critical tool in developing and implementing equity management policies that are consistent with sound business practice and planning. Modeling enables a cooperative to test and set objectives at a level to support the optimum mix of debt and equity in order to minimize the cooperative's rate of return requirements and to meet its debt coverage obligations. In addition, it enables the cooperative to adhere to the cooperative principle of retiring capital credits back to its members as tangible evidence of ownership.

An electric cooperative, like any other business, functions in a dynamic environment. Change is constant and the cooperative doesn't always have control over that change. The needs of a cooperative's membership, along with the strategic goals of the cooperative, must be continually re-evaluated and balanced. Each cooperative's board and staff have an obligation to move the cooperative in the direction that best positions the organization for the future. While the future can't be precisely predicted for each electric cooperative, we do know that the stronger the organization is financially, the more likely they are to meet the promise of service to their membership.

CFC has recently reintroduced an equity management modeling package. The package includes four of the most common capital credits retirement alternatives. The software is currently available on CFC's Web site at www.nrucfc.coop (through the Extranet). CFC regional vice presidents and staff also are available to conduct in-depth equity management presentations to cooperative boards and staff.

The following checklist includes questions designed to help a board be sure it considers the important issues that

Appendix 7: Glossary

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

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.

cooperative
A business that returns its margins to the members through capital credits allocations and retirements.

discount
To calculate the present value of an amount that would otherwise be received in the future to reflect the time value of money.

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

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

mutual company
A business that uses any margins above the cost of providing services to reduce costs in future years. Examples of mutual companies include mutual insurance associations, such as State Farm Insurance, and credit unions, such as the Agriculture Federal Credit Union. There are also a number of mutual electric associations.

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

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.

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 plant assets, less the expenses incurred to supply those services.

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.

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.

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

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.

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.

The information in this Report of the Capital Credits Task Force is intended to be a helpful resource, not an exhaustive and complete examination of capital credits issues. Although this information may be helpful, decisions regarding capital credits policies and procedures are within the discretion and judgment of local electric cooperatives. Because these policies and procedures will vary depending upon state law and specific facts and circumstances, and because the law governing capital credits may change, it is imperative for a cooperative to consult with its legal counsel, as well as its tax and accounting consultant, when reviewing and analyzing the information in this report.

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