Electric Co-operatives: From New Deal to Bad Deal?

By Jim Cooper[1]

Abstract: Most people who live or work in rural America must buy their electricity from their local co-operative, a unique and largely unregulated type of utility. Each customer owns an average of $1,625 of equity in the co-op, although most customers are not aware of their ownership or its significance. Many co-ops are customer-friendly but many are not; some are actively hostile. Legislation should require co-ops to be more efficient, promote conservation, disclose ownership interests to customers, and, for larger co-ops, convert those interests into securities. These reforms could unlock $3 billion to $9 billion of benefits for customers.

Overview

America's 930 electric co-operatives[2] are the sole source of electricity for homes, farms, and businesses in portions of 47 states.[3] Although 66 co-ops ("G&Ts") also generate and transmit wholesale electricity, the 864 distribution co-ops ("co-ops") simply resell and deliver electricity to retail customers across the crucial "last mile"[4] between the national electric power grid and the end-user. Nationwide electrification is considered

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[1] Cooper (HLS '80) is in his third term as U.S. Representative from the 5th Congressional District of Tennessee and represents the service areas of two electric co-operatives. The author would like to thank Cicely Simpson and James Leuschen for their research assistance, and Luke Froeb and Ted Stroll for their useful comments.

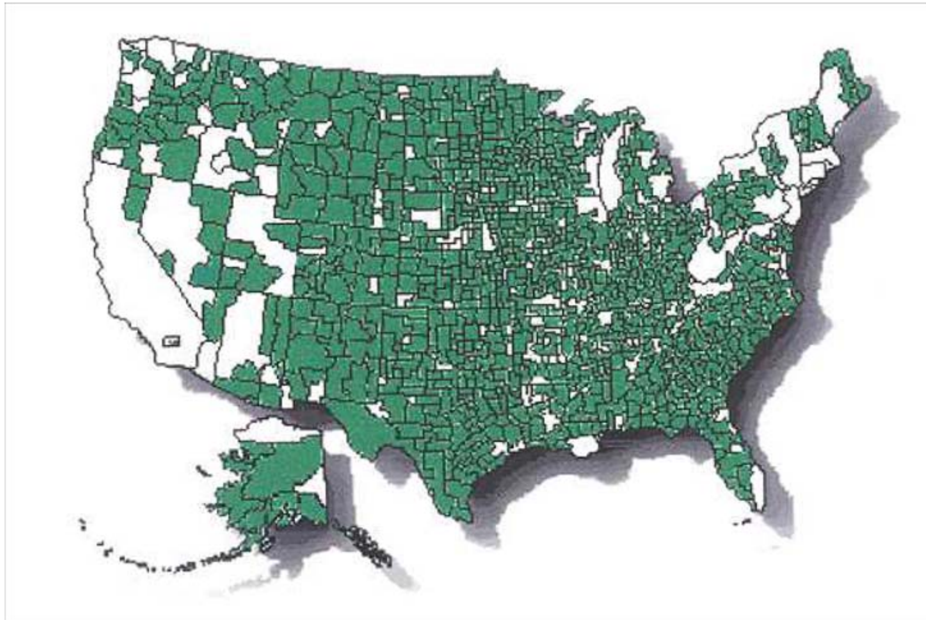
[2] See the National Rural Electric Co-operative Association's (NRECA's) public website, http://www.nreca.org/AboutUs/Co-op101/Co-operativeFacts.htm, accessed Dec. 19, 2007.

[3] Massachusetts, Connecticut, and Rhode Island are the only three states without co-ops. See NRECA public website, *ibid*.

[4] This term from the telecommunications industry refers to the connection between the cable, trunk or optic fiber lines and homes and businesses. This connection may be a few feet or a few miles. Cf. The telegraph

by engineers to be the greatest accomplishment of the 20th century.[5] It is hard to imagine life without it.[6]

Map of Electric Co-op Service Areas



The shaded areas of the map are served exclusively by electric co-ops.

Despite reaching 75% of the nation's land area, co-ops serve only 5% of the population or 17 million customers.[7] Most co-ops serve only a few rural counties where customers live miles apart, although an increasing number of co-ops serve populous

in the late 1800s never made this connection to average homes and businesses. See TOM STANDAGE, THE VICTORIAN INTERNET (Berkley Books, 1999).

[5] "Taken in its entirety, the grid is a machine, the most complex machine ever made. The National Academy of Engineering called it the greatest engineering accomplishment of the 20th century. It represents the largest industrial investment in history." PHILLIP F. SCHEWE, THE GRID: A JOURNEY THROUGH THE HEART OF OUR ELECTRIFIED WORLD 1 (Joseph Henry Press, 2007).

[6] As the U.S. Supreme Court noted in Craft v. Memphis Light, Gas, and Water Division, 436 U.S. 1, 18 (1978), "utility service is a necessity of modern life; indeed, the discontinuance of water or heating for even short periods of time may threaten health or safety."

[7] Roughly half of the nation's farmers are estimated to be served by electric co-ops, partly due to the eventual expansion of private and municipal power companies into rural areas, and partly due to the decline in numbers of farms. See RICHARD B. HEFLEBOWER, CO-OPERATIVES AND MUTUALS IN THE MARKET SYSTEM 131-132 (Univ. of Wisconsin Press, 1980).

suburbs. The median co-op has 12,000 customers. Regardless of size, co-ops strive to deliver reliable, standardized electricity,[8] and to quickly restore service after storms, fires, and floods. Maintaining a network of 2.4 million miles of power lines and utility poles is hard work.[9] Virtually every pole also carries the telephone lines and television cables of unaffiliated telephone co-operatives[10] or private telecommunications companies.

Electric co-ops are owned entirely by their customers who are called "members" of the co-op due to their dual role as customer/owner. The mission of co-ops is to provide access to electricity at affordable prices for every potential member in their service area, no matter how remote.[11] Co-op prices for electricity are expressed in pennies per kilowatt-hour, set at the average cost of serving all residential or business customers regardless of the individual or marginal cost of service.[12] Service to non-members and selling other things than electricity to members are limited by law[13] although almost all co-ops are finding ways around the restrictions.[14]

[8] The U.S. standard for retail electricity is 110 volts, 60 Hertz, with near 100% reliability.
[9] This is roughly half of the miles of electric lines in the U.S. See NRECA public website.
[10] There were at least 272 rural telephone co-ops as recently as 2005. See the USDA's RURAL UTILITIES SERVICE, 2005 STATISTICAL REPORT RURAL TELECOMMUNICATIONS BORROWERS (Informational Publication 300-4, October 2005).
[11] "[A]rea coverage, the concept that any customer in an area served by a rural electric system should be able to receive service at the same cost and under the same terms and conditions as all other customers" PATRICIA LLOYD WILLIAMS, THE CFC STORY: HOW AMERICA'S RURAL ELECTRIC CO-OPERATIVES INTRODUCED WALL STREET TO MAIN STREET 16 (CFC Press, 1995).
[12] Sometimes called the "postage stamp rate" because it does not vary with distance. See SUSAN M. JOHNSON, ELECTRIC CO-OPERATIVES: ON THE THRESHOLD OF A NEW ERA 27 (Public Utilities Reports, Dec. 1995). Nothing prevents different rates for different classes of service, however, so co-ops usually distinguish between residential, commercial, and industrial loads. Some go beyond those classes in an effort to recover the marginal cost of new service.
[13] Sales to non-members and sales of products other than electricity generates unrelated business income (UBI) which is limited to less than 15% of gross revenues of the co-op in order to preserve co-op status. For a discussion of the UBIT issue, see BURTON A. WEISBROD, TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR 83-104 (Cambridge Univ. Press, 1998). For a

People who live in U.S. cities or towns usually buy their electricity from a different type of distributor, either a municipally-owned power company ("muni") or a for-profit company (investor-owned utility or "IOU"). IOUs are much larger than co-ops; munis vary with the size their sponsoring city or town, from large to extremely small.[15] Both IOUs and munis have more flexible financial structures than co-ops[16] but usually do not compete with co-ops for customers[17] because each type of distributor has, except in rare circumstances,[18] a monopoly in its own service area.

Electric co-ops have a much smaller industry share than munis or IOUs, but they still control $97 billion of assets and $30 billion of member equity. This $30 billion may

discussion of the services that co-ops are allowed to offer, see NRECA Slide Presentation, "How Can Your Co-operative Meet the Legal Challenges of Restructuring and Diversification," Wallace F. Tillman, Moderator, at www.co-operative.com. Some co-ops have entered other businesses, such as propane distribution, but face tax consequences for their actions. See IRS Revenue Ruling 2002-54.

[14] In 2003, 93.5% of co-ops responding to a survey indicated that they offer, or own businesses that offer, one or more services in addition to basic electric energy. NRECA AND NATIONAL RURAL UTILITIES CO-OPERATIVE FINANCE CORPORATION (CFC), CAPITAL CREDITS TASK FORCE REPORT 30 (January, 2005), at www.co-operative.com, the password-protected website of NRECA and CFC. See also NRECA's "Electric Consumer Bill of Rights" which includes, "The right to use consumer-owned not-for-profit utilities to provide additional services that meet the needs of their consumers and communities." www.nreca.org/AboutUS/Co-op101/ElectricConsumerBillOfRights. For a survey of state laws permitting additional services, see www.co-operative.com/government/publicpolicy/issues.

[15] The nation's 220 IOUs have assets of $694 billion, and the 2,000 munis have assets of $170 billion. IOUs serve an average of 35 customers per mile, munis serve 47 per mile, and co-ops co-ops average only 7 customers per mile. See NRECA public web page. See also, Robert J. Michaels, "Municipal Electric Utilities: Past and Future," California State University at Fullerton, paper delivered at World Research Group's Conference on Public Power in a Restructured Electric Industry, Washington, D.C., Dec. 7-8, 1995.

[16] IOUs are owned by investors or shareholders of the for-profit power company, and munis are owned by the taxpayers of the municipality. IOUs and munis have more available sources of equity capital than co-ops, which can only receive equity from their own members.

[17] "Territorial protection was an equally important objective, because efforts by private power companies and municipalities to take over populated areas and the more attractive rural loads threatened the ability of many co-operatives to meet area coverage goals at reasonable rates." THE CFC STORY, p. 16.

[18] Municipal annexation of co-op territory is the primary source of conflict between types of distributors.

be the largest "lost" pool of capital in America,[19] lost because so few members are aware of their ownership. Unlike direct shareholders of IOUs who have chosen to purchase shares in a power company, or taxpayers who automatically subsidize their city's muni, co-op members have unknowingly obtained legal title to co-op equity.[20] Unfortunately, however, most co-op members have none of the normal perquisites of ownership.

This article focuses on the primary obligation[21] that electric co-ops owe their members: "at-cost" service, i.e. the lowest feasible electric bills.[22] For distribution co-ops, this means both low electric rates and timely return of equity.[23] Today it also means reducing electricity waste -- the quantity of unneeded electricity purchased -- an unimaginable problem in the early days of co-ops. Unfortunately, there is not enough data to tell whether most of today's co-ops offer these benefits. What is clear is that most

[19] $30 billion is roughly comparable to the market value of Amazon.Com, a major public company.
[20] Although members' rights to receive co-op equity do not vest until actual retirement and receipt of the capital credit, the right to eventually receive the credit matures upon allocation of the credit on the books of the co-op. Even prior to allocation, the co-op is obligated to assign credits to members according to usage. Therefore, although credits are technically not in the member's name until retirement, there is no other legal claimant for the credits. See NRECA AND NATIONAL RURAL UTILITIES CO-OPERATIVE FINANCE CORPORATION (CFC), CAPITAL CREDITS TASK FORCE REPORT (LEGAL SUPPLEMENT) 12 (January, 2005), at www.co-operative.com, the password-protected website of NRECA and CFC.
[21] The duties of co-ops are summarized in the first element of the NRECA's Electric Customer's Bill of Rights, which says: "Consumers have a right to expect reliable, affordable, and safe electric power. Consumers have a right to expect uniform standards of electric power across the country as they travel or move." NRECA public website, http://www.nreca.org/AboutUs/Co-op101/ElectricConsumerBillOfRights.htm, accessed Dec. 19, 2007. As the head of the NRECA, Glenn English, summarizes the duty this way, "Basically, it's to keep the lights on and the rates down. Our success or failure will be judged on how we do this job." Remarks, Las Vegas Convention, March 20, 2007, *ibid*.
[22] "[O]perate at cost – a fundamental requirement to become and remain a "co-operative" under federal tax law and a basic requirement under most electric co-operative acts." CAPITAL CREDITS TASK FORCE REPORT (LEGAL SUPPLEMENT) 4. Low-cost power has not always been the top priority of co-op managers. A 1968 survey "ranked providing reliable service as the most important of five service issues and providing dependable power supply on reasonable terms second. Low retail rates were ranked as the least important." THE CFC STORY, p. 31.
[23] "Every electric co-operative should have a policy for annually allocating capital credits, and, subject to the board of directors' discretion and the co-operative's financial condition, annually retiring capital credits." CAPITAL CREDITS TASK FORCE REPORT, p. 30.

distribution co-ops have a financial incentive to sell more electricity, not less. It is also clear that co-ops have tried to hide information from their members -- information that owners are entitled to in other business contexts. Freed from member scrutiny, co-op managers have often failed to serve their members' interests.

The trade association and lobbying arm of co-ops, the National Rural Electric Co-operative Association (NRECA), seems to be aware of many of these problems but has difficulties persuading its own membership. For example, NRECA has long admitted that many small co-ops keep electric rates artificially high simply because of their refusal to merge with other co-ops.[24] The NRECA has acknowledged that average co-op electric rates are 9 percent higher than neighboring IOUs,[25] but this masks greater disparities. An estimated 350 co-ops charge at least 15 percent more than the closest IOU while another 175 co-ops keep rates 30 percent higher.[26] These higher rates harm ratepayers in order to keep small co-op managers employed.[27] This conflict becomes stark when co-op members receive a buyout offer from a neighboring IOU. As NRECA admits, "When faced with the tempting offer of a $1,000 check and a 20 percent reduction in electric rates, consumers naturally weigh that against the value of belonging to a co-operative."[28]

[24] "Many co-ops are now considering mergers as a means to reduce costs and rates, because consumer size of a co-op is the most statistically significant indicator of a distributor's costs. For example, is a 3,000 member co-op merged to become a 15,000 member co-op, it could reduce costs by average of $220 per customer per year. Can we afford not to consider mergers?" NRECA, GLENN ENGLISH, ED., A FRAMEWORK FOR CHANGE 34 (NRECA, 1996).
[25] A FRAMEWORK FOR CHANGE, p.26.
[26] *Ibid*.
[27] Co-op managers are the highest paid co-op employees and the most likely to lose their jobs due to the synergies of a merger.
[28] A FRAMEWORK FOR CHANGE, p.28.

Instead of merging and lowering rates, however, most co-ops have used member equity to fund anti-takeover efforts.[29]

Some regions of the country have been more difficult than others. Contrary to national co-op policy, Tennessee Valley Authority[30] co-ops have refused to refund any member equity.[31] A series of TVA Inspector General Reports concluded that dozens of distributors – both co-ops and munis – were guilty of mistreating their members twice: first by maintaining excess reserves and then by raising electric rates unnecessarily.[32] Valley distributors had the political clout to get the first Report suppressed[33] and the second Report stripped of the names of any offending distributors.[34] In addition,

[29] From 1985 to 1995, co-ops thwarted 105 takeover attempts and territorial disputes using a fund coordinated by NRECA and CFC. "Of the 510 member systems responding to a CFC survey, 326 indicated a willingness to contribute 5 percent of their patronage capital to the fund. Most of the respondents agreed that establishing the fund was an appropriate rural electric objective." THE CFC STORY, pp. 214-215.
[30] The TVA was established by Congress in 1933 to improve navigation, prevent flooding, promote development, and provide electricity in rural areas. See 16 USCA §§831-831ee.
[31] See McCarthy v. Middle Tennessee Electric Membership Corporation, 466 F.3d 399 (6th Cir.). An officer of one outside-the-valley co-op, Mike Bash, the CFO of Conexus in Minnesota, called the TVA practice "obscene and inappropriate," as quoted in Naomi Snyder, *Should Electric Co-ops Give Customers a Refund?*, NASHVILLE TENNESSEAN, April 11, 2004.
[32] Tennessee Valley Authority, Office of the Inspector General, Inspection Report: "Review of TVA's Role as a Rate Regulator," 2005-5221, June 13, 2006. See also, TVA, Office of the Inspector General, Audit Report: Distributors' Surplus Cash and Investments, Audit 92-0540, February 23, 1994.
[33] "We recognized that our second report, which was initially classified as a "final report," would cause problems and; therefore, we elected to not identify the distributors by name, but rather by number… we also recognized the fact that this information could not be withheld under FOIA [Freedom of Information Act], or for that matter from an inquiring Congress… After discussing the audit with the Chairman [of TVA]… I decided it would be in TVA's best interest to reclassify the report as a draft. By doing so, it would preclude shrill media attention focused on one issue – cash position – and this would obscure more comprehensive efforts which are currently underway to deal with this complex issue." Memo by William L. Hinshaw, II, TVA Inspector General, Dec. 1, 1992, OIG File No. 92-0540.
[34] E.g. "the normal range for cash ratios is five to eight percent… We… identified 50 distributors with cash ratios ranging from 12.5 percent to in excess of 50 percent… Thirty-two of the 50 distributors had rate increases in FY 2006." 2006 Final Report, supra, p. 7. The distributors are never identified by name or number in the Report.

although TVA itself has sporadically promoted energy conservation,[35] most Valley co-ops have been unenthusiastic about educating ratepayers about ways to reduce their electric bills. After 70 years of public power, Tennessee leads the nation in per capita residential electricity consumption.[36]

Anecdotal evidence of co-op abuse in other parts of the U.S. includes an Alabama co-op that failed to hold elections for board members for 38 years.[37] A suburban Atlanta co-op turned over its entire operation to a for-profit subsidiary that diversified into "pest control, mortgages, consulting, a customer call center, staffing, security systems, natural gas and another co-op in South Carolina."[38] A suburban Ft. Worth co-op borrowed a billion dollars to buy a golf course, Westin hotel, and shopping mall, then declared bankruptcy.[39] Another Texas co-op has been accused of overpaying its executives, keeping its board and membership uninformed, and acquiring a failing New Mexico software firm.[40]

As embarrassing as these examples are, co-ops have even greater potential for mismanagement and self-dealing. The close relationships of small-town life, coupled

[35] In 2002, the GAO reported that other public and private utilities had "gone further than TVA in implementing demand-side management programs" to reduce peak load demands and emissions. GAO Report, *TVA Plans to Reduce Air Emissions Further, but Could Do More to Reduce Power Demand*, March 8, 2002.

[36] State energy profiles are available on the U.S. Department of Energy's Energy Information Administration website, http://tonto.eia.doe.gov/state/state_energy_profiles.cfm.

[37] See Margaret Newkirk, *Power to the People? Members Rebelled; Co-op Changed; Customers Challenged Leaders in Struggling Alabama Electrical Co-operative, Turned Light on Utility's Finances*, ATLANTA JOURNAL-CONSTITUTION, August 20, 2007.

[38] *Ibid*.

[39] Steven Mufson, *Defaults Plague Little-Known Lender*, WASHINGTON POST, April 30, 2007, at D1.

with interlocking boards of directors and unclaimed millions of dollars, can flood local banks, brokerages and car dealerships[41] with co-op funds. Employees can be hired to do no work.[42] Benefits to insiders can easily become more important than benefits to ratepayers, especially if ratepayers are not looking.[43] Politicians are not blind to these locally powerful political machines.[44]

Utility misbehavior should be rare, but co-ops are barely regulated at either the federal[45] or state[46] level. Co-ops often deny that they are "utilities" in order to avoid such

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[40] See Claudia Grisales, *Pedernales Board Chairman Has Made $1 Million Since 2001, But Doesn't Remember Much*, and *General Manager Is Firmly in Control of Co-op, Workers Say*, AUSTIN AMERICAN-STATESMAN, Dec. 9, 2007, p. 1.

[41] "A conflict of interest can arise under a variety of scenarios… Another example is a situation in which the board is asked to approve a substantial purchase for fleet vehicles and one director is a close relative of the automotive dealer from which the co-op is considering purchasing its vehicles." Roberta Aronson (CFC), Susan Olander, and Tracey Steiner (NRECA), *Governance and Accountability in Today's Business Climate: How Do Electric Co-operatives Measure Up?* MANAGEMENT QUARTERLY, Vol. 44, No. 3 (Fall 2003) 31.

[42] See Claudia Grisales, *Pedernales keeps paying when some are away from job*, AUSTIN AMERICAN-STATESMAN, Jan. 6, 2008.

[43] For example, the retiring General Manager of Pedernales Electric Co-operative, Bennie Fuelberg, obtained a $2 million deferred compensation package from the co-op without disclosing it to members of the co-op. AUSTIN AMERICAN-STATESMAN, *supra*, p. 1.

[44] NRECA has contributed $1.4 million to federal and state politicians in recent election cycles. Steven Mufson, *supra*, at D1. The Center for Responsive Politics ranks NRECA as the 65th largest donor in American politics from 1989 to 2006, with contributions of $9.9 million. Alicia Malone, *Numbers Show Unions Favor Dems with Political Contributions*, TARGETED NEWS SERVICE, Oct. 4, 2007, at 3.

[45] The Federal Energy Regulatory Commission regulates transmission of electric power, not retail distribution. "Under the Federal Power Act… electric co-operatives with outstanding financing from RUS are not subject to the full authority of the FERC." See NRECA Legal Reporting Service, "The Role of the Co-op Board as "Regulator"," March 2003, pp. 2-4. The Securities and Exchange Commission does not regulate most co-ops despite the resemblance of capital credits to securities. See 15 U.S.C. §77b(1). For determination of whether co-op membership interests are "investment contracts" or "certificate of interest or participation in a profit-sharing agreement" see United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 851-52 (1975).

[46] "Co-operatives in 43 states are subject to some form of state regulation, including 24 states that exercise some degree of statutory authority over rates." Capital Credits Task Force Report, p. 61. For a look at state enabling acts, see "State Regulation of Electric Co-ops Survey Compilations," Nov. 2007, www.co-operative.com. For a history of how co-ops stopped or streamlined regulation in several states, see THE CFC STORY, pp. 186-189.

jurisdiction[47] and to lay claim to a broader mission.[48] The fact that they can successfully deny the obvious is testament to their political influence. Co-ops can often have it both ways: state utility commissions may not set rates but they can settle disagreements about co-op service areas and other technical matters.

The U.S. Department of Agriculture's Rural Utilities Service (RUS)[49] has oversight of co-ops that still borrow from it, but is more cheerleader than critic.[50] RUS actively promotes co-ops by offering engineering, accounting, and marketing advice.[51] The RUS received $3.89 billion dollars in annual appropriations in 2006, or an average of $4.3 million per co-op/per year.[52] According to NRECA, this support is less generous to co-ops than the federal tax code is to munis and IOUs,[53] but it is nevertheless significant. The RUS even delegates governmental authority to co-ops to select worthy local projects for federal grants and interest-free loans.[54] This grant-making authority has often

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[47] See ROGER D. COLTON, THE REGULATION OF RURAL ELECTRIC CO-OPERATIVES 19-25 (National Consumer Law Center, 1993), for an excellent history of co-ops' exemption from state utility commission regulation.

[48] "Co-operatives were recognizing the fact that they weren't electric utilities. They were social service organizations providing electric service… Our job was to make sure we were giving them the tools that they would need to fulfill their social purpose." THE CFC STORY, p. 201. In fact, the new bank that would finance much of the growth of the co-ops, the CFC, only received tax exempt status from the IRS due to its "social welfare purpose." *Ibid*. p. 65.

[49] 7 USCA §901 et seq.

[50] The RUS conditions loans and loan renewals on adherence to loan agreements which require minimum performance ratios for co-operatives. See 7 CFR XVII (1-1-03 Ed.) 1718, Subpt. C, App. A.

[51] See the RUS website, http://www.usda.gov/rus/electric/index.htm, accessed on Dec. 19, 2007.

[52] Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2006, P.L. 109-97, Nov. 10, 2005, 119 Stat. 2142.

[53] The NRECA claims that munis received $909 million in federal subsidies in 2005, or $55 per customer, and that IOUs received $3.3 billion, or $35 per customer. Co-ops received $1 per customer. See "Comparisons of Federal Assistance to Public Utilities," www.nreca.org/PublicPolicy/ElectricIndustry/Taxation.htm, accessed on 10/25/07.

[54] The name of the program is USDA's Rural Economic Development Loan and Grant Program (REDLG) and it has funneled $330 million for such projects through co-ops. Testimony of Hon. Glenn English, pp. 3-4, citing co-ops ability "to work in partnership with business and community leaders for all types of economic development projects – business incubators, medical and educational facilities, water systems, emergency vehicles, value-added agricultural processing, manufacturing sites, etc."

backfired, however, because co-ops have "used discretionary funds to invest in businesses located in urban areas and a variety of securities and commercial paper" instead of creating jobs in rural areas.[55]

As a lender to co-ops, the RUS underwrites and guarantees 35-year loans at favorable interest rates,[56] although it no longer offers the two-percent loans that were available for decades. Cumulatively, the RUS and its predecessor agencies have loaned $39 billion to distribution co-ops and $52 billion to G&Ts. Defaults on these loans have been rare, partly due to easy credit from RUS. The NRECA estimates that RUS programs cost only $25 million annually although the federal government's contingent liability is several billion dollars.[57]

The few teeth in RUS regulations are found in RUS loan covenants and its annual surveys of co-op financials, which restrain co-op spending and standardize co-op reporting. However, almost half of co-op financing today comes from a private, not-for-profit, co-op-owned lender, the National Rural Utilities Co-operative Finance

[55] U.S. Dept. of Agriculture Inspector General Report, "Rural Utilities Service Electrical Generation and Distribution Borrower Investments," Audit Report No. 09601-1-Te, March, 2000, p. ii.

[56] For a discussion of the three basic loan types: "hardship," "municipal," and "Treasury," see Tadlock Cowan, Congressional Research Service Reports for Congress, "An Overview of USDA Rural Development Programs," Jan. 18, 2007, pp. 18-19. Also see GAO Report, "Opportunities to Better Target Assistance to Rural Areas and Avoid Unnecessary Financial Risk," June, 2004, pp. 6-9.

[57] Testimony of Hon. Glenn English, p. 3, "It is important to note that the RUS electric loan programs will cost federal taxpayers less than $25 million to help capitalize a rural electrical infrastructure that is the envy of the world." However, the 2004 GAO Report, supra, p. 13, indicated that taxpayers faced a theoretical risk of loss of $3 billion in 2003, but that "in the event of default, likely maximum losses could be as much as $1.5 billion."

Corporation (CFC) using federal loan guarantees.[58] CFC borrowers no longer have to disclose their financials, reducing oversight of the industry.[59]

Co-ops continue to be largely free from regulation[60] due to political reluctance to interfere with what appear from the outside to be smoothly-running operations. Co-op members don't complain much and politicians are afraid of angering co-op managers.[61] Co-ops are so influential inside their communities and keep such a low-profile outside that they are rarely in the news, except for occasional scandals.[62] If pressed for an explanation of their failure to even monitor co-ops, lawmakers cite customer-ownership as the reason. In theory, electric co-ops are continually self-regulating,[63] just as agricultural co-operatives are.[64]

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[58] Testimony of Hon. Glenn English, CEO of NRECA, Senate Committee on Agriculture, Nutrition, and Forestry, June 20, 2006, p. 3. The primary outside lender is the National Rural Utilities Co-operative Finance Corporation (CFC), the official history of which is, THE CFC STORY: HOW AMERICA'S RURAL ELECTRIC CO-OPERATIVES INTRODUCED WALL STREET TO MAIN STREET, CFC Press, 1995.

[59] For example, although the NRECA indicates on its website that there are 930 electric co-ops, the most recent report from the U.S. Department of Agriculture only lists 607 as RUS borrowers in 2005, down from 612 in 2004. See 2005 STATISTICAL REPORT: RURAL ELECTRIC BORROWERS, USDA RURAL DEVELOPMENT UTILITIES PROGRAMS 9 (Informational Publication 201-1, December 2006).

[60] Cf. Stephen J. Piecara and Janet Marchibroda, *Primer on Rural Electric Co-operatives*, THE CO-OPERATIVE ACCOUNTANT 13-16 (Fall, 1994), which claims that co-ops "operate in a highly regulated environment," but which admits that only 17 states regulate co-op rates. The article complains about conflicting accounting standards for co-ops among FASB, SEC, REA, FERC, and the state utility commissions.

[61] "Our political strength will maintain REA for some of us, I am sure, for the foreseeable future," THE CFC STORY, p. 259. See also note __.

[62] See notes __ and __ supra, and Editorial, ST. PETERSBURG TIMES AND HERNANDO TIMES, Nov. 20, 2007, at 2 ("Florida has endured its share of ridicule because of its voting system. But the election methods being used by the Withlacoochee River Electric Co-operative make the state's system look like it is state-of-the-art.").

[63] See NRECA Legal Reporting Service, "The Role of the Co-op Board as "Regulator"," March 2003.

[64] See NRECA's "Electric Consumer Bill of Rights" which says, "As recognized by federal courts, since the consumer owns the co-operative, there is no motive for the co-operative to mislead, cheat, overcharge, or act in any way that is not in the consumer-owners' interests." www.nreca.org/AboutUS/Co-op101/ElectricConsumerBillOfRights, accessed on Dec. 19, 2007. "There is no need for protecting the members of the co-operatives from themselves." Colton, *supra*, p. 20, quoting Treadway, *The Public Utility Status of Rural Electric Co-operatives in Illinois*, 40 ILL.L.REV. 515, at 526 (1946) and Merrills, *Rural Electrification Co-operatives*, 20 TENN. LAW REVIEW 406 (1948).

History of Electric Co-ops

Electric co-ops were created as one of President Franklin Roosevelt's New Deal programs in order to promote rural development.[65] When Roosevelt was elected in 1932, people living in cities had been enjoying the benefits of electricity for many years. Urban power companies were slow to reach out into the countryside, however, because of the high cost of wiring farms.[66] Frantic federal officials invented a new type of utility in 1935 to fill the need. Part government agency,[67] part agricultural co-operative,[68] and part not-for-profit company,[69] this curious hybrid was named for the most innocent-sounding of its three components: co-operative.[70]

The word co-operative has deep resonance for rural Americans due to the perceived fairness of its organizational structure and its widespread use in agriculture.[71]

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[65] "Roosevelt decided now that whatever government control of electric power would remain; the government would also begin to control power in new areas. He had four goals. The first was to provide electricity to homes and farms – many farms were still without. The second was to increase the use of electricity in all homes, providing Americans with a better standard of living. The third was to reduce the cost of electricity to the average consumer. And there was a fourth, more ephemeral goal: that through the electricity industry the New Deal might create a new and more prosperous form of society. AMITY SHLAES, THE FORGOTTEN MAN: A NEW HISTORY OF THE GREAT DEPRESSION 175 (Harper & Collins 2007).

[66] "[C]ompanies usually required that farmers, individually or along a road, pay as much as $2000 per mile to cover the cost of additional distribution lines, an unusual practice now. Prior to 1940, few farmers could make such outlays and also pay for wiring homes and for appliances." Heflebower, p. 132.

[67] The federal government allowed co-ops to borrow up to 100 percent of the cost of building distribution lines, and, when electricity could not be purchased at low enough prices, for generation capacity as well. Heflebower, *supra*.

[68] Federal law never defines "co-operative" so advocates are able to mix elements from different statutes, and from common law, to fit different situations. See JOHN A.C. HETHERINGTON, MUTUAL AND CO-OPERATIVE ENTERPRISES: AN ANALYSIS OF CUSTOMER-OWNED FIRMS IN THE UNITED STATES 108 (University Press of Virginia, 1991).

[69] Co-ops are not-for-profits. THE NATIONAL SOCIETY OF ACCOUNTANTS FOR CO-OPERATIVES, FINANCIAL REPORTING BY CO-OPERATIVES, Revised 1999, p.32-11.

[70] The more socialist-sounding name of "people's utility district" was also allowed, but never gained currency. Heflebower, *supra*.

[71] There were 3,346 farmer co-operatives in the U.S. in 2000, with 254,658 employees. Katherine L. Hanson, "Co-operatives in Agribusiness," USDA Rural Business-Co-operative Service, Information

The co-operative principles of "user-ownership, user-benefit, user-control, and limited returns to the co-op"[72] seem neighborly and safe. Using these principles, many agricultural co-operatives have been quite successful. Most observers have naively assumed that electric co-ops follow these all of these co-operative principles since they share the name.[73] The failure of the federal government to define "co-operative" has added to the confusion.

Unfortunately, electric co-ops are not true co-operatives[74] because they are not voluntary associations of people with specific expertise in the co-operative venture.[75] Although co-op membership may have been voluntary during the Depression when electricity was an exciting novelty, today it is a daily necessity. Customers do not freely choose to join an electric co-op; they buy from the monopoly because they have no choice. Their options are to go along or "go dark," or possibly "go off-grid" by generating their own electricity. Co-ops not only effectively coerce membership[76] with

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Report 5, March, 2002, p. 2. See also, for example, JERRY VOORHIS, AMERICAN CO-OPERATIVES (Harper & Bros., 1961).

[72] Donald A. Frederick, *Co-ops 101 – An Introduction to Co-operatives*, Rural Business Co-operative Service, USDA, Co-operative Information Report 55.

[73] See, e.g., CAPITAL CREDITS TASK FORCE REPORT 17-18. "Seven Principles Distinguish Co-ops from Other Electric Suppliers. 1. Voluntary and Open Membership. Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination." Of course, no IOU or muni could discriminate against customers either, so this is not a difference with other electric suppliers. From a customer standpoint, voluntary membership means that you have a realistic alternative to co-op service but, with local electric monopolies, there is no such alternative.

[74] The first co-operative was formed in Rochdale, England in 1844 on the basis of what came to be called the "Rochdale Principles." Using many similar principles, an estimated 48,000 co-operatives of all types in the United States are generating $120 billion in economic activity for 100 million members. Hanson, supra.

[75] See, for example, Thomas W. Gray and Charles A. Kraenzle, *Problems and Issues Facing Farmer Co-operatives* (USDA Rural Business Co-operative Service, Research Report 192, 2002).

[76] "Because electric and telephone co-operatives have exclusive rights to serve specified rural areas in most states, anyone living in those areas must join the co-operatives. That exclusivity of service is unique to utility co-operatives." Hanson, supra, p. 46.

tie-in sales but few, if any, co-op customers are knowledgeable about the electricity business. Co-op customers have other jobs and will sign almost anything to get electricity. The unique nature of electric co-ops is reflected in the state statutes under which most co-ops are incorporated, statutes that treat electric co-ops differently than agricultural or other co-ops.[77] The federal tax code also distinguishes them.[78] Unfortunately, most courts have failed to note these crucial differences between agricultural and electric co-ops, and the need for greater protection of co-op members.

Despite their identity problems, electric co-ops were the business prodigies of their time. The first co-op was born in 1934 in the back of a furniture store in Corinth, Mississippi,[79] but within a few years had a thousand siblings scattered across the nation. Before they were twenty years-old, electric co-ops had accomplished the impossible: wiring 90% of their service territories. No private companies had ever stretched copper wire faster, over longer distances, or been a conduit of more federal subsidy dollars.

Source: Electric Co-operatives.

As their local monopolies matured, electric co-ops eventually reached the remaining 9% of customers who were hardest to reach. Some co-ops are still struggling

[77] For a survey of state co-op statutes, see CAPITAL CREDITS TASK FORCE REPORT 59-60 ("Electric co-operatives in approximately 30 states are organized under specific electric co-operative acts.") For a survey of agricultural co-op statutes, see JAMES R. BAARDA, STATE INCORPORATION STATUTES FOR FARMER CO-OPERATIVES, (Reprinted 1987, USDA, Agricultural Co-operative Service, Co-operative Information Report Number 30).

[78] See CAPITAL CREDITS TASK FORCE REPORT 54-58; TOUCHE & ROSS, CO., ACCOUNTING AND TAXATION FOR CO-OPERATIVES 323 (4th Ed., 1978). See also LEE F. SCHRADER AND RAY A. GOLDBERG, FARMERS' CO-OPERATIVES AND FEDERAL INCOME TAXES (Ballinger Publishing, 1975) for an in-depth discussion of non-electric co-operative taxation.

[79] DAVID E. LILIENTHAL, TVA - DEMOCRACY ON THE MARCH 19 (Harper & Brothers, 1944).

to make money in rural areas that remain poor, but some are now serving the richest urbanized counties in America.[80]

Co-ops were wildly popular in their youth. Ending the drudgery of washing clothes by hand, cooking with coal or wood, or reading by kerosene lamps was considered miraculous, especially since the private sector had failed at the job. Early co-op members felt reverence for the co-op's achievements. The official history of electric co-ops is entitled "The Next Greatest Thing," the first being God himself.[81] Co-ops were not satisfied with being competitive – unrivalled service was the goal.[82] This missionary zeal is preserved in co-op statutes that still require that "co-operative education" be funded by co-ops, ahead of any member benefits.[83] Taken literally, this requirement means that $30 billion, comparable in size to the endowment of Harvard University, is available to educate Americans about this alternative to capitalism.

The Chairman of the TVA, David Lilienthal, offered an eye-witness account of an electric co-op annual meeting in the 1940s:

[80] 29.2% of co-ops now serve metropolitan areas (including 9.4% of co-ops which serve counties with over one million residents), 46.4% serve counties with more than 2,500 urban residents, and 24.4% serve counties with fewer than 2,500 urban residents (although one third of these most rural co-ops are adjacent to metro areas). According to the 2004 GAO Report, *supra*, pp. 10-12.

[81] RICHARD A. PENCE, ED., THE NEXT GREATEST THING: 50 YEARS OF RURAL ELECTRIFICATION IN AMERICA 2 (NRECA, 1984).

[82] Even today the NRECA's "Electric Consumer Bill of Rights" concludes by saying "co-operatives should be able to work together to provide a 'yardstick' by which all consumer can measure the performance of the market and market participants." www.nreca.org/AboutUS/Co-op101/ElectricConsumerBillOfRights

[83] "Revenues of a co-operative for any fiscal year in excess of the amount thereof necessary:…6. To provide a fund for education in co-operation and for the dissemination of information concerning the effective use of electrical energy and other services made available by the co-operative, shall… be distributed by the co-operative to its members as patronage refunds…" CAPITAL CREDITS TASK FORCE REPORT 59.

> "I have been at such meetings where throughout a whole day as many as two thousand farmers and their wives and children discussed the financial and operating reports made to them by their superintendent and board of trustees [of the co-op], and later while we ate a barbecue lunch watched new uses of electricity demonstrated… But these membership "town meetings" are not simply business sessions. They have an emotional overtone, a spiritual meaning to people who were so long denied the benefits of modern energy and convenience which had become a commonplace to their city neighbors. The talk turns to the hard days before "we won our fight," to the dark difficulties that had to be gone through before the crews came down the road, the poles were set, the copper lines were strung, and the lights went on."[84]

Speaker at an electric co-op annual meeting in 1948. Note the multi-year comparison of co-op operating results displayed on the blackboard directly in front of the speaker.
- Picture from THE NEXT GREATEST THING (NRECA, 1984).

As the decades passed, attendance at annual meetings fell because members started taking electricity for granted, even wasting power that had been considered precious.[85] No one wanted to discuss co-op financial statements anymore. Co-op managers were busy maintaining existing power lines instead of building new ones.

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[84] Lilienthal, *supra*, pp. 19-20.
[85] "The estimate is between 5 and 10% of our annual power bills is consumed by this so called phantom or vampire power. Another estimate is that 75% of the electricity used to power home electronics is still

They boosted revenues by increasing customer density and by promoting appliances. They focused on higher co-op revenues, not lower member bills. Even the legal mandate for co-operative education dwindled into an automatic subscription to a co-op magazine with massive circulation but barely a mention of co-op mechanics. [86] Co-op insiders gather regularly at state and national conventions but do little to educate anyone, even themselves, about co-ops.[87] The most informative NRECA website, www.co-operative.com, is password-protected so that no outsider can access it.[88] Most insiders also seem to be unfamiliar with the site.[89]

Today, fast-growing metropolitan areas like Atlanta, Orlando, Washington, D.C., Cincinnati, Ft. Worth, Austin, Denver, and Nashville have penetrated deeply into co-op service territory, blurring the lines between urban and rural, although many co-ops like to

consumed even when we think the devices are turned off." Speech by James M. Andrew, NRECA Regional Meeting, Sept. 26, 2007, pp. 25-26, on file with the author.

[86] See, for example, THE TENNESSEE MAGAZINE which is "published monthly to communicate electrical use and safety, economic development, educational and community interests of more than 770,000 Tennessee families and businesses who own, operate and control the tax-paying, business-managed, locally owned electrical distribution and service systems of the Tennessee Electric Co-operative Association… Cost of subscription to members of participating electric co-operatives is $2.40 per year (20 cents per month), plus periodicals postage paid from equity accruing to the member. For non-members, a subscription is $10 per year or $25 for three years. Single copy, $1." Volume 47, No. 11, p. 4, November, 2003. The "total paid circulation" of this magazine in Tennessee was 523,847 in 2003. *Ibid*., p. 24.

[87] See Claudia Grisales, *Pedernales Co-op executives – and their spouses – go first class: Credit card bills document spending habits of utility's top officials*, AUSTIN AMERICAN-STATESMAN, Jan. 6, 2008. Pedernales Electric Co-operative board President W.W. Burnett testified that he had served on the co-op board for 40 years, making $190,000 in 2006 and $1 million since 2001, but could not remember if he had ever seen a co-op budget, knew if the board had committees, or reviewed executive compensation. See Grisales, AUSTIN AMERICAN-STATESMAN at 1. See also Andrews speech, supra, pp. 8-9, "we all went to board meetings and did an hour or so deciding on a Ford or Chevrolet. Then the manager would present the REA report and it involved borrowing a million dollars for the future work plan. We would spend about five minutes on the report…Long debate on trucks, short discussion on borrowing millions to operate the co-op."

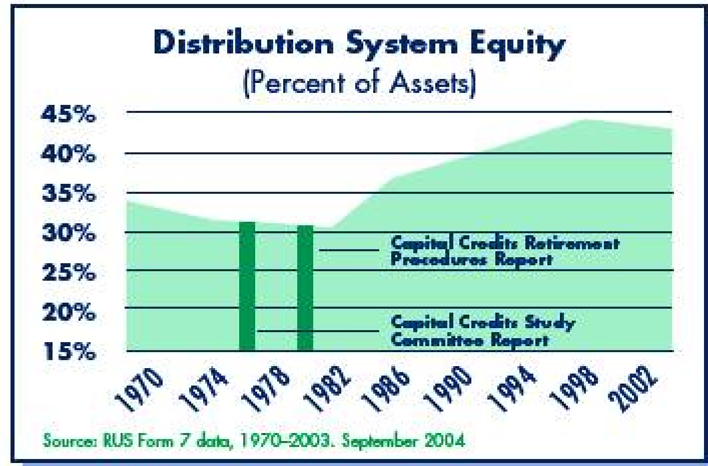
[88] See www.co-operative.com for the username and password protection. My congressional office was denied permission by NRECA to access the website for research on this article, but access was obtained by other means.

[89] Author's conversations with a wide variety of co-op managers.

keep the adjective rural in their name.[90] Regardless of how urbanized their territory has become, all co-ops can still receive federal loans under a policy entitled, "once rural, always rural." If you were eligible for government assistance in 1936, you are still eligible today.[91]

Today every co-op is about 70 years-old. As co-ops aged, their equity grew from zero in 1936 to $30 billion. Despite this success, co-op managers have been surprisingly reluctant to share the news, or the money, with their members. NRECA began noticing this unexpected but fundamental problem in the mid-1970s, urging co-ops to return equity to their customers more quickly.[92] Unfortunately, co-ops did the opposite, boosting equity levels to new highs as shown on the accompanying NRECA graph. After further warnings published in 1996, the NRECA commissioned another, more urgent report on capital credits in 2005, urging prompter and larger returns of equity.[93]

[90] For a list of co-ops by state, see the NRECA's public website, www.nreca.org.
[91] See Tyrus H. Thompson, "Editorial: Once Rural, Always Rural," NRECA Legal Reporting Service, Vol. 40, No. 9, Sept. 2004 ("has been brought to the attention of Congress many times… not enacted provisions or provided guidance for addressing or altering the Once Rural, Always Rural principle").
[92] In 1975, only 127 co-ops out of 1,050 refunded capital credits despite high levels of equity, causing NRECA to form the first Capital Credits Study Committee, which issued is "Final Report and Recommendations" in February, 1976. Apparently, many co-ops did not get the hint, so the NRECA created a more focused Capital Credits Retirement Procedures Task Force which issued its specific recommendations in 1980. CAPITAL CREDITS TASK FORCE REPORT, p. 13.
[93] CAPITAL CREDITS TASK FORCE REPORT, *supra*. See also the CAPITAL CREDITS TASK FORCE REPORT (LEGAL SUPPLEMENT).



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

Capital Credits Task Force Report, p. 13.

The reason for NRECA insistence on greater return of "capital credits" is that the legal and tax status of co-ops depends on such a policy. Under current law, failure to enforce an adequate capital credit policy could force a co-op to become either a taxable co-operative or an IOU.[94] NRECA still considers co-op resistance to be a problem despite the fact that 84% of eligible[95] co-ops are returning some capital credits annually.[96] The reason for NRECA concern is the fact that co-ops are accumulating

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[94] CAPITAL CREDITS TASK FORCE REPORT, *supra*, pp. 54-58.
[95] CAPITAL CREDITS TASK FORCE REPORT, supra, p. 13, footnote 1.
[96] Ibid, p. 13. See also, e.g., Associated Press Wire, Kalispell, Montana, *Flathead Electric to Rebate $3 Million to Customers*, Oct. 30, 2007; HOOSIER TIMES, Martinsville, Indiana, *SCI REMC Members to Get $750,000 in Capital Credits This Holiday*, Dec. 15, 2007; The Business Journal, *Energy United Awarding Members Capital Credits*, AMERICAN CITY BUSINESS JOURNALS, Dec. 17, 2007.

much equity faster than they are refunding it.[97] Equity was up $2 billion in 2006 alone, but only $499 million was refunded.[98]

It is noteworthy that NRECA could have a multi-decade disagreement with their members on such a fundamental issue. Clearly it is touchy; the major NRECA reports on capital credits are worded diplomatically and found only on their password-protected website, not in the public domain. NRECA knows that co-op managers simply do not want to relinquish control of their members' funds. Some managers fear that members might want too much of their money back because they might not understand that co-op equity is illiquid.[99] Co-op managers should know that they effectively control member opinion because there is little to prompt an inquiry or a complaint. Members seem grateful for any refund they receive,[100] having no way to compare it to size of their investment in the co-op or to what other co-ops are paying. In co-ops that refuse to refund, there are no membership certificates to remind members of their ownership because most co-ops were formed so quickly and with little expectation of profit.[101]

[97] NRECA advocates using "Boatman's Theorem" to help co-op managers calculate and pay larger refunds. The Boatman Theorem indicates that the "percentage amount of equity that should be returned each year is equal to the difference between the co-op's rate of return on equity… and the co-op's growth in capital." CAPITAL CREDITS TASK FORCE REPORT, p. 37.

[98] Vital Signs, pp. 43 and 49. This increase in "Net Margins and Patronage Capital" was $112 per co-op customer in 2006.

[99] Conversations of various co-op managers with the author.

[100] According to a survey conducted by NRECA, 70% to 80% of co-op members like refunds, and a majority of members over 55 think that refunds occur. Younger members are more skeptical, with only 33% of 19-43 year-olds believing that co-ops refund capital credits. CAPITAL CREDITS TASK FORCE REPORT, p. 66.

[101] As late as the early 1950s, about 20 percent of electric co-ops were operating at a loss. Heflebower, p. 133.

Today, if certificates are offered at all, they are sold as souvenirs,[102] not as tangible proof of an account that is growing in value.

Even accountants,[103] lawyers,[104] and businessmen[105] have trouble understanding the unusual rules that apply to co-ops. Take, for example, the co-op practice of "special retirements." This common bylaw allowed spouses of deceased co-op customers to obtain a refund of all or part of their capital credits, often to pay for burial expenses. Sadly, co-op practices like this are not always honored[106] despite substantial national payouts in 2006.[107] Member-friendly co-op managers should never fail to mention the "special retirement" opportunity to the widow.[108]

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[102] For example, in the "About Us" page of the Middle Tennessee Electric Membership Co-operative website, the question is asked, "Do the members actually own the co-operative?" The co-op's answer is: "Yes. Members pay $5 for a membership certificate, which grants the rights and privileges of ownership." But the co-op never explains what those rights and privileges are. Www.mtemc.com/Whats_a_co-op.htm 8/17/00.

[103] Co-op accountants have their own association, National Society of Accountants for Co-operatives, and journal, The Co-operative Accountant. The autobiography of a certified public accountant who claimed to have been the auditor of more electric co-operatives than anyone else reveals many of the quirks of the business. See WALTER G. SCHMIDT, RURAL AND SUPPLY CO-OPERATIVES WERE MY CONCERN 176 (WL-PAN Press, Kansas City, 1987).

[104] Co-op lawyers are encouraged to belong to the Electric Co-operative Bar Association in order to keep up with co-op law. NRECA, *Sample Electric Co-operative Attorney Policy*, revised Oct. 31, 2003, p. 8.

[105] Very few business schools offer courses on co-operatives. In fact, the word co-op or co-operative often has an entirely different meaning of worksite apprenticeship so that the student can obtain practical experience in business or industry before graduation. See http://en.wikipedia.org/wiki/Co-operative_education.

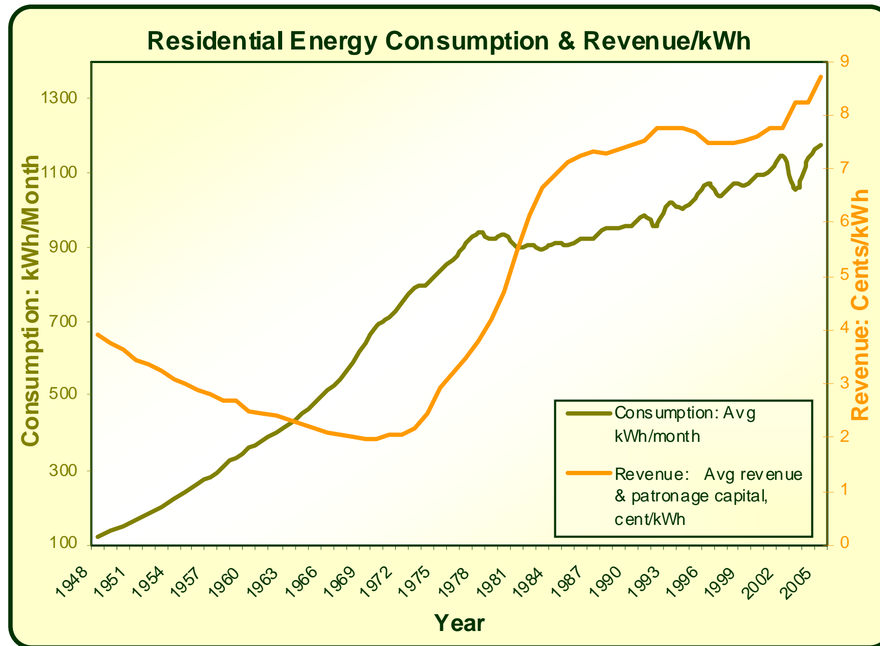
[106] MTEMC Bylaws state, "when in the judgment of the Board of Directors, the financial condition of the Co-operative justifies it, the Board may authorize the repurchase of the membership of any deceased member, such membership to be held by the Co-operative as a treasury membership which may be disposed of by the Board of Directors upon non-discriminatory terms." Revised Aug. 16, 2003, Art.I, Section 9(b).

[107] In 2003, $94 million of special retirements were made, versus $351 million in general credit retirements. CAPITAL CREDITS TASK FORCE REPORT, pp. 9 and 43-47.

[108] NRECA urges its co-ops to pay attention to the age of its members in order to better anticipate their attitudes and needs. CAPITAL CREDITS TASK FORCE REPORT, p. 65.

The genius of co-ops has been their adaptability, aided by their hybrid nature, to gradually changing conditions. As the following chart shows, most co-ops have been through three phases, each one featuring a different hybrid element. Co-ops looked much like "government agencies" from 1936-73 because they were so heavily dependent on the federal tax dollars. Co-ops resembled true "co-operatives" from 1974-84 because member equity was sufficient. Finally, co-ops grew more ambitious and began acting like "not-for-profit" or even for-profit businesses from 1985 to the present.[109] Of course, each co-op has matured at its own rate, depending on its local service area, so it is difficult to generalize. Some small co-ops are still in their "government agency" stage, and may remain so. Some still act like genuine co-operatives. But others grew so rapidly that they quickly became, like the Atlanta co-op that subcontracted out its entire operation, distressingly similar to for-profit enterprises.

[109] Changes in government loan policy did much to shape until behavior. Until 1973, the REA offered direct two-percent loans to co-ops, then shifted to five percent loans and loan guarantees in an effort to get government out of the lending business. "What Mr. Nixon did in 1973 was the greatest thing he could have done and the worst thing he could have done. It created the guarantee program for the G&Ts which made billions of dollars available that would not have been available at the two percent rate… The bad part was that it allowed us to make, in hindsight, some poor decisions." THE CFC STORY, p. 114. See ELECTRIC CO-OPERATIVES, pp. 18-24. The next big shift in government lending policy was in 1993, when the Clinton Administration moved to market rate loans, reserving 5 percent loans for only the neediest borrowers. In the shadow of government withdrawal from the utility lending market, CFC and CoBank filled the void. THE CFC STORY, p. 267.



Graph based on ELECTRIC CO-OPERATIVES, p. 22, updated by James Leuschen.

Many co-op observers, including many co-op directors, have not kept up with the gradual transformation of co-ops from emergency relief agencies[110] to, in some cases, wealthy power companies.[111]

Not only does excessive equity endanger co-op status, it also makes them attractive takeover targets despite numerous barriers to acquisition, particularly against IOUs.[112] A more subtle danger to co-ops is their attractiveness as a financing source for

[110] See note 44, *supra*.
[111] "[T]he same people were sitting on the boards who were sitting on the boards when the co-op was founded. These were well-meaning, dedicated individuals, but the co-op they were involve with in the early days was no longer the same organization 30 years later. It was a more complicated, more sophisticated operation, and a lot of directors didn't keep up to date. There was a crying need for turnover." THE CFC STORY, pp. 48-49.
[112] "Sellout exposure: Could failure to retire capital credits lead to internal or external pressure to sell the co-operative?" CAPITAL CREDITS TASK FORCE REPORT, p. 11. Most state co-op statutes have a variety of anti-takeover protections, particularly against IOUs, such as a requirement that other co-ops be given a first right-of-refusal before any acquisition could take place. These protections limit the "market for corporate control" described by Henry G. Manne, *Market for Corporate Control*, THE JOURNAL OF POLITICAL ECONOMY 110-120, Vol. 73, No. 2, April, 1965.

the estimated $35 billion in new generating capacity that may be needed in America over the next thirty years.[113] Co-ops are being targeted due to their deep pockets, tax-favored status, and (except for a few G&Ts) relative inexperience in power generation.[114]

Co-ops nationwide are being asked by NRECA to conduct “Straight Talk” campaigns in their communities in order to spread the message that “rates are going up” because of new generation and pollution controls.[115] This message is popular with co-op managers because it means increased revenues and blames outsiders for any problems the co-ops may face. But these “Straight Talk” efforts are also an opportunity for co-ops to level with their members on all issues, including ways of reducing members’ bills with internal reforms like efficiency, capital credit retirement, conservation and avoiding unnecessary plant construction and pollution-control costs.

[113] See the 2006 NRECA Annual Report, particularly the letters from the Chairman and the CEO, promoting 15,000 megawatts of new power generation for co-ops. Www.nreca.org.
[114] See Associated Press, *Distributors want to help fund TVA plans for new power stations: Group would have ownership stake in venture*, THE TENNESSEAN, Jan. 7, 2008 B2.
[115] See Glenn English NRECA Annual Meeting Remarks, March 20, 2007, p. 12.

Member Control of Electric Co-ops

A. Equity Interest

Customers own their co-op. The more electricity a member buys from the co-op, the more equity he or she owns. The average monthly electric bill in 2006 was $102 for a co-op residential customer.[116] These bills are not itemized; customers cannot see the wholesale cost of electricity, cost of retail distribution, overhead and interest expense, or the co-op equivalent of profit -- the roughly 3% to 7% "margin" on top.[117] In good years, the co-op accumulates this operating income margin[118] much like retained earnings. The accumulated margin is called "capital credits," "patronage capital," "member equity," or "total earnings reinvested in the system," depending on each co-op's preferred terminology.[119] Today almost every co-op has millions of dollars, if not tens or even hundreds of millions of dollars capital credits[120] which, when allocated to members according to their usage, defines the member's exact legal ownership of the co-op.[121] When this equity is finally transferred to members, it may be called "capital credits,"

[116] NRECA Strategic Analysis 4.27/07. Www.co-operative.com.
[117] A FRAMEWORK FOR CHANGE, p. 34.
[118] Non-operating income, such as investment income or money management income, may not accrue to member's benefit. CAPITAL CREDITS TASK FORCE REPORT, p. 25.
[119] Middle Tennessee Electric Membership Co-operative uses the term "Total earnings reinvested in the system." MTEMC Annual Meeting Financial Report, 2003.
[120] In 2005, only 15% of co-ops failed to report positive margins and the average co-op equity level is 42%. Statistical Report.
[121] There appears to have been a long-term disagreement between REA and the IRS about the need to promptly allocate margins to customers. "My advice to our clients was to assign all margins to patrons and to notify the patrons as required by the IRS." See Schmidt, p. 175 . NRECA comes down strongly on the side of annual allocation. CAPITAL CREDITS TASK FORCE REPORT, p. 24. Allocation does not mean rights to capital credits have vested; vesting occurs only when the credits are retired. *Ibid*, p. 33.

"refunds,"[122] "return of capital," or "dividends."[123] In short, for about $5 extra every month, co-op members own a growing share of an electric utility, whether they want to or not.

The converse of the customer/owner principle is that, if you are not a member of the co-op, you are not allowed to own any of it, thereby restricting the co-op's source of capital to insiders. Co-ops' deep suspicion of outside capital[124] extends even to their own wealthy members who are not allowed to buy more equity in the co-op than their usage would dictate. Co-ops overcame their initial lack of equity with long-term loans from the Rural Electrification Administration, the predecessor to the RUS, for up to 100% of the cost of line construction or power generation. As start-up enterprises in poor rural areas, co-ops could not have survived without receiving and distributing federal funds as quasi-governmental agencies.

The average co-op member owns roughly $1,625 of equity in his or her co-op,[125] but accounts can range from hundreds of thousands of dollars for heavy commercial users to almost nothing for new customers. Although $1,625 is *de minimis* for some people, the average American family has only $3,105 in brokerage accounts and $3,469 in

[122] See R. Jeff Turnage, *TAMs Bring Good/Bad New on Patronage Dividends*, THE CO-OPERATIVE ACCOUNTANT, Summer, 1996, p. 61 for a description of a wide variety of terms for these payments.
[123] Members of rural electric co-operatives "share in the operational profits, just like members of other co-operatives, through patronage dividends." See CO-OPERATIVES IN AGRIBUSINESS, p. 48.
[124] Not only do co-ops fund themselves with member equity, even their debt comes either from the government (RUS) or a co-operatively-owned lender, CFC. Even a newer lender like CoBank is a subsidiary of a government-sponsored enterprise.
[125] This rough calculation divides total co-op equity ($30 billion) by total number of co-op customers (17 million). Data are from NRECA's public website.

checking and savings accounts.[126] Like stock, co-op equity conveys to the owner an interest in the residual assets of the co-op in the event of liquidation. Unlike stock, it is often overlooked, not only by its owners but also by bankruptcy courts,[127] divorce courts, welfare administrators, and others with a claim on the member's assets.

The exact nature of this member property interest is unclear. Co-ops treat it in several different, inconsistent ways: as an investment, loan, capital contribution, or even as a charitable donation.

- **Investment?** Since a member's margin payment becomes equity in the co-op, it resembles an investment. Indeed, that term is commonly used in co-op literature although it differs from a normal investment because it does not pay explicit dividends or interest.[128] NRECA acknowledges that members rightfully expect significant benefits from their investment, if only due to their opportunity cost, but its intangible benefits are hard to identify.[129] The argument that the margin payment is an investment has very serious consequences because member equity

[126] Survey of Consumer Finances 2004, http://www.federalreserve.gov/pubs/oss/oss2/2004/bull0206.pdf, accessed Dec. 19, 2007.

[127] See CAPITAL CREDITS TASK FORCE REPORT (LEGAL SUPPLEMENT), pp. 39-49.

[128] "Patronage capital, capital credits, member equity – by any name, any co-op revenues in excess of expenses, or margins, are investments by members in the organization and ultimately belong to the members and should be returned to them… A co-operative member does not receive a return on this investment in the co-operative, other than the ability to buy power essentially at cost." ELECTRIC CO-OPERATIVES, p. 83.

[129] "While each member is different, the cost of its equity investment in the co-op is probably at least as high as the return the member could expect to earn on a similar investment, such as a 10-year Treasury bond, and may be as high as a credit card rate." Capital Credits Task Force Report, p. 37. See also, "the member should still attempt to measure the return provided by the investment in the co-operative. One measure may be the lower price paid on products or services purchased… A member must evaluate the transaction price, plus the value of patronage refunds and the discounted value of retains to be received in

could then become a "security" under federal securities law.[130] The legal argument hinges on investor's initial expectation of return,[131] a test which makes little sense in the context of forced membership in electric co-ops.

- **Loan?** Since many co-ops return members' margins after twenty years, usually without interest, it resembles a bad loan because, after inflation, members receive roughly half the value of their original margin payment.[132] Members usually don't complain about this return because they have low expectations. They are largely unaware that the growing prosperity of their co-op allows the return of more margin dollars, and without a twenty-year delay.

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the future, to arrive at the total return on investment." USDA, *Co-operative Financing and Taxation* (Rural Business-Co-operative Service, 1995).

[130] Most co-op securities cases involve agricultural, not electric, co-operatives. Although U.S. v. Davis (40 F. Supp. 246 (N.D. Ill. 1941) found that co-operative membership certificates were profit-sharing agreements under the 1933 Act, and Reves v. Ernst & Young, 494 U.S. 56, 65 (1990) presumes that co-operative financial instruments are securities if they are specifically named in the '33 Act, courts have resisted finding that co-operatives issue securities. See L. Keith Parsons, *Federal Regulation of Co-operative Securities Transactions: An Update*, THE CO-OPERATIVE ACCOUNTANT, Spring, 1990, p. 35.

[131] The so-called Howey test (SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946)) was reiterated in United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 851-52 (1975). The Howey test requires four elements to be present in any security: an investment of money, in a common enterprise, with an expectation of profits, to be derived solely from the efforts of others. The most recent case, Great Rivers Co-operative of Southeastern Iowa v. Farmland Industries, Inc., 198 F.3d 685, 699-701 (8th Cir. 1999), noted:

> [T]he capital credits lack the essential characteristics of a security. First the class members enter into the co-operative relationship not in expectation of the profits that will be generated from such a relationship but instead to reap the benefits of that relationship. The capital credits are non-interest bearing and thus do not provide the valuable return on an investment normally expected from the purchase of a security… any distribution of 'profits' were patronage refunds, i.e. a price or cost adjustment, resulting from the member's own transactions with [the co-operative].

[132] 43% of co-ops that refund capital credits use the first-in, first-out method to benefit the oldest members. These co-ops often use a 20-year rotation cycle, although length of the cycle can vary. The nation's largest co-op, Pedernales, has just started a 30-year cycle, by refunding margins loaned to the co-op in 1977. See CAPITAL CREDITS TASK FORCE REPORT, p. 41.

- **Capital Contribution?** The argument for capital contribution is that it conveys intangible benefits,[133] like membership in a country club. According to the NRECA Electric Consumer Bill of Rights, "The co-op difference resides in customer ownership and control."[134] Perhaps because this control is so tenuous, the NRECA advocates return of capital credits because that shows "tangible evidence of members' ownership in the co-operative and demonstrates the difference between co-operatives and other organizations."[135]

- **Donation?** If you truly believe that margins are hopeless investments or loans, it is a short step to believing that they are charitable gifts for the good of the co-op and the community.[136] Co-ops encourage this view with "Operation Roundup" and trips to Washington for co-op youth,[137] however, this confuses the 501(c)12 status of co-ops with the 501(c)3 status of charities. Electric co-ops are not charities; they are not-for-profits that are free to pursue profit as a secondary objective.[138]

[133] "A co-operative member does not receive a return on this investment in the co-operative, other than the ability to buy power essentially at cost." ELECTRIC CO-OPERATIVES, p. 83.
[134] www.nreca.org/AboutUS/Co-op101/ElectricConsumerBillOfRights.
[135] ELECTRIC CO-OPERATIVES, *supra*.
[136] Business customers get the same deduction whether the electricity purchase was an ordinary and necessary expense or a donation.
[137] Many co-ops boast of their charitable work funded by members choosing to "round up" their utility bills to the nearest whole dollar. This, of course, slightly increases members bills, although it is done voluntarily, and without a tax deduction for the donating members. Many co-ops also invite selected high school students in the co-op's service area to travel to Washington, D.C. at co-op expense, in whole or in part.
[138] CAPITAL CREDITS TASK FORCE REPORT, pp. 54-58.

Regardless of how the co-op member's margin payment is classified, return on that payment is central to the operation of the co-op.[139] In fact, failure to return capital credits can destroy the tax-exempt status of the co-op by depriving customers of membership status.[140] Despite the centrality of this requirement, it is hard to find a single co-op that can prove it has returned the right amount of capital credits, or, for that matter, kept member rates low or electric bills at a minimum. Co-ops don't want you to check their results; they argue that pure co-op procedures automatically produce superior results.[141]

What about co-op procedures? Co-op business software keeps exact accounts of each member's allocated ownership in dollars and cents, but these accounts and amounts are seldom, if ever, revealed to members, or allowed to vest until the actual refund occurs.[142] Since co-ops are in constant touch with members by means of monthly bills and issues of co-op magazine, this failure to communicate is troublesome. Another concern is the simplistic, self-serving financial information that is released annually to co-op members in lieu of financial statements.[143] Members receive less factual

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[139] "[A]llocating and retiring capital credits are two of the practices that distinguish co-operatives from other businesses… Adopting and implementing a capital credits policy are key responsibilities of a co-op's board of directors and management. Capital Credits Task Force Report, p. 9. "[A] utility co-operative's patronage dividend ('capital credit') policies are crucial to its competitive position and financial integrity." Thomas M. Strait, *Patronage Dividends of Electric and Telephone Co-operatives*, THE CO-OPERATIVE ACCOUNTANT, Summer, 1995, p. 58.

[140] Bill Clayton (CFC) and Russell D. Wasson (NRECA), *Introduction to Utility Co-operative Taxation*, April 28, 2005. See www.co-operative.com.

[141] See, e.g., *The Role of Co-op Board as Regulator*, supra.

[142] See note ___. The exact sequence capital credits returning to members – allocation, vesting, retirement, and distribution – is seldom revealed to members, and seems poorly understood by co-op managers themselves. See Capital Credits Task Force Report, including the (Legal Supplement).

[143] Non-members lack access to any co-op financial information because co-ops are viewed as private companies, not quasi-government agencies. TVA began marking its annual "Summary of Financial Statements, Sales Statistics, and Rates: Distributors of TVA Power" as "Business Sensitive" starting with

information than the owners of any other widely-held companies. Comparisons with other co-ops' performance are never made. This paternalistic treatment makes it extremely difficult for anyone but a specialized researcher to understand a single co-op, much less the industry's performance. The only new window on co-op performance is the availability of IRS Form 990 disclosures on any tax-exempt entity, but these are usually several years late.[144]

Co-ops must meet a variety of conditions in order to be tax-exempt. These are A) *act like a regular co-operative* by subordinating capital and ensuring democratic control, allocation of capital, and operation at cost,[145] B) *focus on the co-operative's primary business*, i.e. receive at least 85 percent of income from member purchase of the co-operative's products or services, in this case, electricity,[146] and C) *act like a true electric co-operative:* prohibition on retained earnings "beyond the reasonable needs of the co-op," open records so that members can "determine, at any time, each member's rights and interests in the assets of the organization," and non-forfeiture of member interests.[147] NRECA seems worried that many co-ops may be violating one or more of these sets of conditions.[148] There are three levels of penalty for failing these tests: become a taxable electric co-op, a taxable general co-operative, or even becoming an IOU.[149]

June 30, 2002 data in order to limit access to the information of public power utilities. See also Austin American Statesman.

[144] See www.guidestar.org or foundationcenter.org for tax returns for co-ops. See also, ECBA, *About Hot Topics in Form 990 Compliance*, NRECA, Powerpoint Presentation, June 12, 2007.

[145] IRC Section 5019c)12; Exempt Organizations; Proposed Examination Guidelines Regarding Rural Electric Co-operatives, Announcement 96-24, 1996.

[146] *Ibid.*

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

[148] Issuance of the 1976, 1980, and 2005 Capital Credits Reports, using increasingly urgent language, plus the repeated admonition "A co-operative's policy for allocating and retiring capital credits must comply

Two of the specific IRS conditions for electric co-ops are easy to understand if not define: bans on excessive reserves and on closed records. The third requirement of non-forfeiture of member assets requires explanation. Termination of a member's capital account is impossible without consent of the member, member's estate, or (in the event the estate's books are closed) his or her descendants. [150] The enduring nature of this obscure property right has surprising implications. State escheat laws and unclaimed property laws usually do not apply, even for capital accounts that have been dormant for decades.[151] The good news for members is that children and grandchildren can still get full credit for the original co-op member's account. The bad news for co-ops is that refusal to refund capital credits or settle with estates results in co-ops that are increasingly owned by former customers, whether they are deceased or living in another area. No one knows how many co-ops have 15% or more of their equity owned by dead or absent customers. This violation of the prohibition on significant non-customer ownership and could also force revocation of a co-op's tax-favored status.[152]

B. Voting Rights in Co-ops

with applicable state and federal laws as well as the co-op's articles of incorporation and bylaws," seems to indicate worry that many co-ops are non-compliant. CAPITAL CREDITS TASK FORCE REPORT, p. 12.

[149] *Ibid*. p. 58.

[150] IRS Revenue Ruling 72-36 regarding 26 CFR 1.501(c)(12)-1: Local benevolent life insurance companies, mutual irrigation and telephone companies, and like organizations.

[151] CAPITAL CREDITS TASK FORCE REPORT (LEGAL SUPPLEMENT), pp. 50-52.

[152] See Bill Clayton (CFC) and Russell D. Wasson (NRECA), *Introduction to Utility Co-operative Taxation*, Powerpoint Presentation, April 28, 2005. See www.co-operative.com.

In contrast to the complexity of co-op capital accounts, the voting rights of members are simple: one member, one vote. Unlike with IOUs, big "shareholders" only get one vote. This radically democratic policy reduces the influence of a large customer in co-op elections, but also reduces his or her interest in participating at all. Co-ops usually ban proxy voting on the New Deal theory that all members should attend annual meetings because nothing could be as important as co-op business.[153] At these annual meetings, quorum requirements are suspiciously low for director elections but impractically high for fundamental changes in the co-op.[154] Requiring a super-majority for mergers or acquisitions makes such transactions nearly impossible in the name of democracy.[155] Conversely, 100 co-op employees may be enough to pick all the directors, sometimes in return for mutual promises of job security. Such rules entrench co-op directors, management, and employees.

Co-ops are governed by a board of directors composed of members from each of the co-op's service areas, elected by general membership. Co-op board seats are very attractive positions but few members apply because they know little about the benefits, which appear to be nominal under the bylaws. In reality, according to the new Form 990

[153] Roger Crotou, *Legislator Says Utility's Reforms Fall Short*, SAN ANTONIO EXPRESS-NEWS, Nov. 15, 2007, p. 1B. Pedernales allows proxy voting, and for petitions from 25 or more members to nominate new members for the board, but still counts unmarked proxies as votes for the management slate.
[154] Published NRECA surveys of state co-op laws focus on either state regulation or state flexibility in allowing new lines of business. Anecdotal evidence includes the Tennessee quorum requirement of the lesser of 100 members or 2% of membership for transacting regular business at the annual meeting (which may fall to 51 people or 1% once a quorum is established), versus a meeting-long requirement of 10% of membership for any substantial asset sale or other major co-op transaction. T.C.A. 65-25-211(d).
[155] For example, the 10% permanent quorum requirement for Tennessee co-ops would mean that, for the largest co-op, over 15,000 customers would have to gather and remain in attendance in order to consider a major co-op transaction. In the current Pedernales scandal, less than one-fifth of one percent of Pedernales membership participated in any way in one of the nine public forums designed to elicit customer views.

disclosures, annual compensation for co-op board members can reach $15,000 to $50,000,[156] depending on the size of the co-op, frequency of meetings, value of health insurance, and attendance at expense-paid state and national conventions. No expertise is required. Co-op board members sometimes display astonishing ignorance of co-op business but are insulated from liability for their decisions due to the co-op's not-for-profit status.[157] Sarbanes-Oxley requirements for independent directors or audit committee experience do not apply.[158] The ability of co-op employees to control these board seats – and, through the directors, the co-op – has made them much more influential than the co-op's apathetic membership.[159] Co-op managers and employees have too often become the *de facto* owners of the co-op.

Claudia Grisales, *Utility Customers Speak Up for a More Open Board*, AUSTIN AMERICAN-STATESMAN, Oct. 21, 2007, p. B1.

[156] See, e.g., Roddy Stinson, P*EC Board's Pay, Perks Are Filed with IRS – And They're Astounding*, SAN ANTONIO EXPRESS-NEWS, Nov. 25, 2007, p. 1B.

[157] See Note 111, supra.

[158] See Claudia Grisales, *Pedernales co-op changes leaders and bylaws, but members are still locked out*, AUSTIN AMERICAN-STATESMAN, Jan. 6, 2008.

[159] For example, in the Pedernales scandal, "co-op employees at the forums were attentive and at times outnumbered those in attendance." Clauda Grisales, *Pedernales Customers Give Co-op Their Ideas*, AUSTIN AMERICAN-STATESMAN, Sept. 29, 2007, at E8.

Co-op Treatment of Members

There is no bright-line test to determine whether a co-op has surplus equity and therefore must lower rates, return member equity, or promote energy conservation. But opportunities for such benefits obviously improve if the co-op can lower its operational expenses without harming service.[160]

Distribution (In)efficiency

The core business of co-ops is distribution: "wheeling" or delivering electricity to local meters for as few cents per kilowatt-hour as possible. Different regions have different wholesale costs of electricity (depending, for example, on the availability of hydro power) but all regions can try to distribute electricity efficiently. In 2005, the average co-op charged roughly one-third of an electric bill, or 2.56 cents per kilowatt-hour, for distribution.[161] This is more than double the one-cent average distribution cost for IOUs, which do serve higher density areas but which are also more efficient.

Co-ops prefer to focus customer attention on their all-inclusive rates, without breaking out the cost of distribution. This policy hides their relative inefficiency and

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[160] A small but telling example of co-op inefficiency was the fact that for the first 40 years of co-ops, all of them used the mail to make their interest payments on RUS (then REA) loans. They lost an average of 60 days of float annually on many billions of dollars. Only CFC's "check delivery" service in 1975 began improving their money management. THE CFC STORY, p. 133. As a result of these reforms, non-operating margins doubled from $33.2 million in 1976 to $62.6 million in 1979. *Ibid.* p. 127.

[161] NRECA, U.S. Electric Utility Overview, Feb. 2007, indicating that the average distribution cost for all utilities is 2.1 cents per KwH. The co-op component is not released but can be derived from the 2005 STATISTICAL REPORT, p. 20. Also A FRAMEWORK FOR CHANGE, p. 30.

allows them credit for low-cost generation. Co-ops also resist focusing on the volume of electricity purchased – the kilowatt hours – although such information could help customers decide how to reduce wasteful purchases. Reducing either the price or volume of electricity threatens co-op management, however, since managers are motivated to improve the co-op's top line, not the member's bottom line. They pay lip-service to conservation, but it is not a priority.[162] An extremely successful conservation program would make the co-op look like it has stopped growing, and no co-op manager wants that.

The relatively high cost of co-op distribution is due to dispersed customers, high number of employees per customer, and excessive investment in capital plant. Scale is the primary factor. The 43 co-ops with fewer than 2,500 customers charge each member $531 for distribution every year, whereas the 144 co-ops with more than 25,000 customers have reduced the cost to $266 each.[163] According to the NRECA, mergers among the co-ops that are uneconomically small could save customers at least $220 each per year, resulting in huge savings for customers: roughly the equivalent of two free months of electricity. Trimming payrolls and right-sizing investment in capital plant can also make distribution more efficient. The median customer-employee ratio is 276 to 1, which could be lowered if co-ops grew larger.[164] As for capital plant, the NRECA has

[162] Electric appliances and street lighting
[163] 2005 STATISTICAL REPORT, p. 18.
[164] NRECA, *Special Report: Vital Signs – How Rural Electric Systems Peformed in 2006*, Powerpoint Presentation, Oct. 2007, p.47.

encouraged members to ask such expenses could be cut in half without loss of service.[165] Today, the average plant cost has climbed to $4,121 per customer.[166]

Timing of Member Benefits

When co-op distribution expenses are excessive, margins are less likely to be available to return to members although, with enough rate increases, even inefficient co-ops can generate positive margins. Since most states do not regulate co-op rates, co-ops are free to raise rates until members revolt at annual meetings, a practical impossibility. Whether or not the co-op is running efficiently, there are several ways of estimating when a co-op has an adequate capital cushion.[167] The appropriate level of equity for co-ops depends on several factors including loan covenants, expected capital needs, and, of course, board discretion.[168]

The simplest financial test of a co-op's ability to benefit members is "equity as a percent of assets." According to RUS loan covenants, the minimum equity threshold is 30% but the RUS recently waived this "current ratio test"[169] for all co-ops. The result is that co-ops with equity levels far below 30% can refund capital credits. Today,

[165] A FRAMEWORK FOR CHANGE, p. 34.
[166] *Vital Signs*, p. 46.
[167] The CFC boasts about its Key Ratio Trend Analysis statistical test, which includes 145 ratios of performance variables for each co-op for the last five years. CFC Press Release, *2006 KRTA Reflects Electric Co-ops' Consistent Financial Strength*, Aug. 29, 2007.
[168] CAPITAL CREDITS TASK FORCE REPORT, p. .
[169] Memorandum from Blaine D. Stockton, Assistant Administrator, Electric Program, to All Electric Borrowers (May 15, 2002), as reported in CAPITAL CREDITS TASK FORCE REPORT (LEGAL SUPPLEMENT), p. 14. See also 7 CFR XVII (1-1-03 Ed.) 1718, Subpt. C, App. A, Section 6.8 "Limitation on Distributions." See also 7 CFR §1717.617 "Limitation on Distributions." Historically, according to Schmidt, "REA

distribution co-ops average 42.01% equity, but many are above 50% or 60% and even reach 92%.[170] These data mean that, although co-ops can safely borrow more than two dollars for every dollar of equity, most co-ops are borrowing much, much less.[171] In contrast, most IOUs maintain higher debt loads due to their creditworthiness, the stability of the utility business, and the high cost of equity in the capital markets.

Another threshold for co-op financial performance is TIER (times-interest-earned ratio) which measures co-ops' ability to repay debt. Most co-ops today easily meet these thresholds. Suggested TIER is 1.25[172] and the median co-op had 2.29 in 2006, or nearly twice the financial strength that is required.[173]

These ratios indicate that co-ops are overcapitalized by roughly 10% to 30% since they pass the "current ratio" and TIER tests so easily that the tests seem obsolete, as demonstrated by the recent RUS waiver of the current ratio test. Individual co-ops vary but, in aggregate, co-ops could offer immediate benefits to their owners of $3 billion to

personnel have urged some of our clients to pay cash dividends to patrons when the members' equity was ten percent or less." Schmidt, p. 174.

[170] 2005 STATISTICAL REPORT, p. 18. "Some co-operatives have reached the conclusion that it is in the members' best interest to finance the co-op entirely through equity, while others would use 100 percent debt financing if possible. The best approach avoids either extreme." CAPITAL CREDITS TASK FORCE REPORT, p. 37.

[171] See Dr. Frank W. Bacon, Dr. Joe Lavely, and Dr. Edward O. Adusci, *Co-operative Debt Usage: The Case of Rural Electric Co-operatives*, THE CO-OPERATIVE ACCOUNTANT, Fall, 1995, p. 36, finding that co-op debt levels have fallen substantially since 1980, and are lower in the Eastern U.S. than in the West.

[172] See 7 CFR XVII (1-1-03 Ed.) 1718, Subpt. C, App. A, Section 5.4, "Rates to Provide Revenue Sufficient to Meet Coverage Ratios Requirements."

[173] CFC Press Release, *supra*.

$9 billion without endangering co-op financial stability; in fact, such a refund policy would strengthen their legal position and relationship with customers.[174]

The irony of RUS loan covenants is that they were drafted to prevent co-ops from being too generous to their members; now the problem is often the reverse: not being generous enough. Equity is accumulating faster than co-ops are returning it to its rightful owners. Not even the blanket waiver of the "current ratio test" has induced co-ops to refund more capital. The "limited benefit to the co-op" principle is being stretched to the limit, as is the tax-favored status of co-ops.[175] As the leading book on electric co-ops states,

> "Any net margin of revenue over expenses is credited to members in proportion to their usage of electricity in the form of capital credits, or patronage capital. No interest is paid on this form of investment, but *co-operatives are required to return this capital to their members*. Size of

[174] If co-op managers were able to designate 5% of capital credits for an anti-takeover fund to improve their own job security, co-ops should be able to return a higher percentage to co-op members. See note __, supra.

[175] "The IRS has rarely challenged the business judgment of boards that fail to authorize capital credits retirements. At some point, however, capital accumulation may exceed any legitimate business need. If challenged by the IRS, this has the potential for serious consequences, such as the loss of co-operative status under federal tax law and member relations problems, which could lead to lawsuits to claim member capital or even action by members to sell the system in order to recoup their investment in the co-operative." CAPITAL CREDITS TASK FORCE REPORT, p.35. "The area of exemption from income tax and my advice to my clients became a source of irritation… Briefly, a co-operative pays no income tax because legally it is a nonprofit. This means that the bylaws of the corporation must demand that the corporation divest itself of margins by turning the margins back to the customer, like a sales discount. According to the IRS, this means calculating the amount and notifying the members of the amount." See Schmidt, p. 175.

> margins and the timing of capital returns are key decisions for the board [of the co-op]."[176] (emphasis added.)

Board refusal to return equity or lower rates reflects their penchant for gilding financial ratios instead of understanding that, regardless of their monopoly status, co-ops are ultimately in a competitive environment. As the chief economist of the NRECA wrote,

> "Co-ops can become much more competitive by simply revising their financial policies. *Reduce margins*. Maintain or *reduce equity*. Reduce general funds. *Increase capital credit retirements to all members*. These can make a big difference." (emphasis added.)

The ability of electric co-ops to obtain virtually unlimited equity from their members, while retaining broad board discretion[177] as to when, if ever, members benefit from their ownership, has not only given them a government-like power to tax,[178] but

[176] "Patronage capital, capital credits, member equity – by any name, any co-op revenues in excess of expenses, or margins, are investments by the members in the organization and ultimately belong to the members and should be returned to them. Patronage capital is allocated to individual members based on the member's use of electricity, or contribution to margins. A co-operative member does not receive a return on this investment in the co-operative, other than the ability to buy power essentially at cost." ELECTRIC CO-OPS, pp. 7 and 83.

[177] See Thomas M. Strait, *Patronage Dividends of Electric and Telephone Co-operatives*, THE CO-OPERATIVE ACCOUNTANT, Summer, 1995, p. 61, "In most cases, the board of directors of electric and telephone co-operatives have considerable discretion in redemption of capital credits. Their bylaws typically provide that redemption of capital credits is within the discretion of the board based on the circumstances and financial condition of the co-operative at that time. Therefore, capital credits allocated to utility patrons normally do not have a readily determinable value and thus do not give rise to income at the time of allocation."

[178] Munis are particularly prone to add city expenses to electric bills, effectively taxing residents through their electric meter for other city services. But co-ops can also cross-subsidize businesses other than electricity unless strict accounts are kept, and, even then, money is fungible.

also created co-op balance sheets unlike any others.[179] Some co-ops operate almost entirely on equity, if only due to their board's distaste for debt. Equity is perceived as either costless,[180] or extremely cheap;[181] therefore debt (even at subsidized interest rates) is co-ops' most expensive form of capital.

This upside-down world of co-op finance has created several anomalies. Co-op managers argue that returning any capital credits to members, or reducing any New Deal subsidies, would force them to raise electric rates faster.[182] Co-op managers are essentially saying that any change in the *status quo* would harm members, an argument which sounds persuasive until you realize that it assumes that co-ops are efficient and should be able to continue confiscating member equity.

The ultimate issue in co-op refund policy is intergenerational fairness. As the NRECA says, "retiring capital credits is a way to ensure that each generation of members pays its own way by providing its own equity."[183] But co-op managers naturally tend to

[179] See Claudia Phillips, *Revisiting Equity Management – The Art of Wise Compromise*, MANAGEMENT QUARTERLY, Winter, 2001.
[180] See, for example, "The refund to members of their capital contributions deprives the co-operative of interest-free equity capital. It increases the cost of doing business…" Wesley M. Jackson, Assistant Chief – Distributor Marketing Branch, Testimony to Capital Credits Study Committee, Oct. 1, 1974, p. 3.
[181] "Since a co-operative is not allowed to pay a rerun on equity contributed by its members, some people say that the cost of equity to a co-operative is zero, but that is incorrect. The Goodwin formula offers a more realistic view. It calculates the return on equity a co-op must earn to maintain equity at a given level while meeting growth needs and retiring capital credits. It shows that there is a cost of equity even for a co-op experiencing very low growth." CAPITAL CREDITS TASK FORCE REPORT, p. 36. The reasoning here is specious, however, because the co-op still gets the use of member funds indefinitely without any cost. It also makes little sense for faster-growing co-ops to automatically have a higher cost of capital, simply because they are growing.
[182] One article found that a Tennessee co-op could refund $366 to each of 150,000 customers while maintaining a current ratio of 40%. Assuming the co-op borrowed the amount of the refund, it would cost each ratepayer fifty cents per month. See Naomi Snyder, *Doing the math: Could your co-op afford to give you a refund*, NASHVILLE TENNESSEAN, April 11, 2004.
[183] Capital Credits Task Force Report, p. 10.

favor new customers over old, knowing that older customers have already paid a lifetime of margins and are powerless to reclaim them. Co-op managers are motivated to boost sales to new members and those with future buying power.[184] If co-ops offer refunds at all, co-op managers increasingly favor "last-in, first out," or "percentage-based," refund plans that favor newer customers.[185] Slowing the benefits to long-time customers subsidizes newer ones with the older customers' equity.

Ways of Benefiting Members

Once a co-op board has determined that there is a surplus in its patronage capital account, and allocated that surplus to its members, it finally has the ability to provide "at-cost" service. The primary tools are reducing rates, volume, or patronage capital. Although economists consider these three member benefits to be similar, they have very different practical effects.

Lowering electric rates benefits members according to their future usage, but rates are very difficult for members to monitor and compare. Most members do not track their bills year-over-year closely enough to appreciate a reduction in millage rates.[186] Lowering electric rates also reduces incentives for conservation. Finally, without

[184] "You might as well burn the money in terms of what it does for your co-operative [refunding capital credits to old customers]. By retiring capital credits on a percentage basis, we felt that current members would see a rebate now, an ownership interest in the system, and better understand the philosophy of co-operatives. If they had to wait 20 or 30 years to get their patronage capital, they wouldn't get the same feeling." The CFC Story, p. 133.

[185] Ibid. p. 41, showing that 36% of co-ops use one of these refund methods, as opposed to 41% for FIFO.

[186] Customer-friendly billing software could help members compare, for example, August 2008 with August 2007.

knowing the size of a member's capital account, it is also hard to compare the rate reduction to member equity.

Lowering the volume of electricity purchased is ultimately up to the customer, not the co-op, although higher rates for electricity at times of peak demand can speed customer decision-making. Co-ops often underestimate the need for conservation which, according to some utility experts, is 75% cheaper than new generation.[187] The co-op is uniquely able to educate customers on the costs and benefits of better home insulation, more efficient bulbs and appliances, or timing the use of appliances at night.[188] Digital readout meters or even a more visible meter location can help customers understand how much electricity they are wasting.

The best course, as the NRECA agrees, is increased return of capital credits. In 2006, $499 million of electric co-ops' $30 billion in patronage capital was returned,[189] although many co-ops, even the most prosperous, never return any credits.[190] An interesting question is whether members should also be able to benefit more directly from the $3.9 billion investment that co-ops have made in CFC, itself a co-operative that it

[187] Author's conversation with Tom Kilgore, the CEO of TVA.

[188] NRECA focuses on statistics like 92% of co-ops "actively educat[ing] consumers on energy conservation" and 41% offering weatherization services, without revealing how effective this education is. See NRECA 2006 Annual Report last two pages.

[189] NRECA website. Interestingly, co-ops are not required to file Forms 1099 to report payments of capital credits, except for business customers who presumably deducted their purchase of electricity. See James Howard Smith, *IRS Proposes Examination Guidelines for Rural Electric Co-operatives*, THE CO-OPERATIVE ACCOUNTANT, Fall, 1996, p. 32.

[190] For example, the 50 co-ops in the Tennessee Valley region have never paid a capital credit. The largest co-op in America, Pedernales, had not paid one until scandal forced them to this year. Claudia Grisales, *Pederanales Execs Plan to Step Down*, AUSTIN AMERICAN-STATESMAN, Nov. 14, 2007, p. A1.

wholly owned by co-ops.[191] Co-ops that make refunds should also disclose the size of a member's remaining patronage account in order to improve co-op accountability.[192]

An indirect member benefit is reducing the environmental harm that power generation inevitably produces. Burning coal produces pollutants such as mercury, sulphur-dioxide, nitrogen-oxide and particulates, which degrade the region surrounding the power plant. Another form of pollution, carbon-dioxide, affects the global environment. Of course, most other energy sources pollute as well,[193] whether CO_2 from natural gas or long-term radioactive waste storage for nuclear plants.

Some co-op managers are glossing over the environmental impacts of their decisions and exerting their political influence to exempt co-ops from laws that apply to other utilities. Montana and Virginia co-ops recently lobbied their U.S. Senators to allow a 20-year delay in complying with new pollution-control standards. [194] They argued that savings from not having to comply with national pollution control requirements are more valuable to their members than cleaner air.[195] It is unknown whether co-op managers considered the damage to customer health that increased and prolonged pollution can

[191] See CFC ANNUAL REPORT 2007, Sept. 13, 2007.

[192] Co-ops that choose to return credits can use the "first-in-first-out method" or the "percentage method." Under FIFO, most co-ops have waited 20 years until they feel it is safe to return a portion of the earlier margin payment, a long time for even the most patient co-op member. The percentage method allows new members as well as old to benefit by returning a small fraction of everyone's patronage account, tilting the balance in favor of newer customers.

[193] New hydro power requires dam construction, interrupting free-flowing streams and often depleating oxygen levels in lake water. Wind power generates noise pollution and harms bird migration. Solar power may involve toxic substances in its manufacture.

[194] Efforts by Sens. Max Baucus and John Warner enabled co-ops in Montana and Virginia to get 20 extra years to meet emissions standards for greenhouse gases, and obtain emission allowances that could be worth as much as $4.2 billion over that time period. Faith Bremner, *Sweet Deal for Montana Rural Electric Co-ops in Climate Bill*, GANNETT NEWS SERVICE, Nov. 8, 2007.

cause. Of course, few co-op members were aware of the decision by co-op managers to lobby on their behalf.

[195] See note __ supra.

Strategies for Change

There are a number of ways that co-ops could return to their pro-consumer roots but each will require a radical change in attitude of co-op directors and managers. These co-op insiders have benefited most from the erosion of co-operative principles and will probably be the chief obstacles to reform.[196] In business-school terminology, this is a "principal-agent" problem because the principals (co-op members) have often lost control of their agents (co-op directors and managers). These agents have frequently seized control of co-ops and sometimes victimized the co-ops' owners. The situation is so severe that even the agents' agents, namely the NRECA and CFC, seem to be quietly siding with the principals.[197] Because it is unlikely that co-op insiders will voluntarily change their behavior, even at the urging of their own advisors, legislation will be necessary.

Restoring the original mission of co-ops – the lowest feasible electric bills for members, including the costs of electricity waste and pollution – will require the following legislative steps:

[196] "To engender member loyalty and attenuate possible take-over threats, some utility co-operatives are considering patronage capital redemption approaches already used by other types of co-operatives. Electric and telephone co-operatives with strong equity balances are considering whether or not the redemption cycle for capital credits can be shortened. Others are examining whether the traditional first-in, first-out redemption approach to a base capital plan, percentage-of-all-equities redemption plan, or another plan which results in earlier redemption to current patrons." Thomas M. Strait, *Patronage Dividends of Electric and Telephone Co-operatives*, THE CO-OPERATIVE ACCOUNTANT, Summer, 1995, p. 62.

[197] If you read the 1976, 1980, 1996, and 2005 NRECA publications cited above, and THE CFC STORY, you will find numerous examples of criticism of co-op business practices, although this criticism is muted. Contrast these documents with the uncritical tone of most NRECA speeches to membership.

- **Operations: Right-sizing co-ops** so that they can better serve member interests. This means enlarging co-ops, promoting conservation, and questioning new generation capacity.

- **Governance: Empowering members** to regain control of co-ops means mandatory disclosure of membership interests, a simple grading system so that members can easily evaluate co-op performance, and, at least for larger co-ops, making membership interests securities. Taking co-ops public is one way to achieve all of these objectives by simple vote of the membership.

- **Subsidies:** After 70 years of subsidies, only co-ops that need government help should receive it: those that serve low-income or difficult-to-serve areas. Threatening to withhold federal assistance is also a way to achieve better compliance with the preceding co-op reforms.

Operations: Right-Sizing Co-ops

In the short term, increasing the number of co-op customers means either expanding service areas or combining with another co-op or power company, either by merger or acquisition. Other co-ops are the obvious merger candidates,[198] but co-ops

[198] Some co-op mergers are already taking place. See, e.g., Lauren Donovan, *Consolidated Co-op OK'd*, BISMARCK TRIBUNE, Dec. 8, 2007 (Oliver Mercer Electric Co-operative and West Plains Co-operative, savings members $5 million over ten years); Jannette Pippen, *Opinions Mixes on Possible Co-op Merger*, THE DAILY NEWS (Jacksonville, N.C.), Nov. 26, 2007 (Carteret-Craven Electric Co-operative and Harkers Island Electric Membership Co-operative, saving $6 million over ten years). For an earlier example of a

should not neglect opportunities to merge with munis or telephone co-ops because both are already community-owned and may provide more synergy. Munis have higher customer density as well as smaller average size, making them ideal takeover targets if local governments can be persuaded to relinquish ownership.[199] Of course, sometimes the merger should go the other way, with munis acquiring co-ops. It will be fascinating to see whether members care enough about belonging to a co-op to revive its atrophied features, or whether "municipalization," i.e. becoming a taxpayer without equity in the local power company, is sufficient. For small patronage-capital holders, the debate is academic; for large accounts, mergers could unlock a lot of value.

Of course, the most aggressive bidders for co-ops may be neighboring IOUs. IOUs are much larger than co-ops and more accustomed to acquisitions. Allowing takeovers from outside the "public-power family" is controversial, but suburban co-ops already have much in common with IOUs. The principle of "member benefit" should guide any such transactions, just as "shareholder benefit" theoretically guides corporations.

The rapid decline in the number of telephone co-operatives in recent decades is an indication of the merger potential of electric co-ops, particularly if their local monopolies

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co-op merger, see Shane Adams, *The Merging of Two Electric Membership Co-operatives*, THE CO-OPERATIVE ACCOUNTANT, Fall, 1999, p. 76.

[199] For an excellent study of many ways of combining a co-op and a muni, see Ron Nichols, Navigant Consulting, *Phase 1 – Draft Report on Cost Savings from Alternative Combination of Municipal Light & Power and Chugach Electric Association*, Nov. 5, 2007, available on the City of Anchorage, Alaska, website: http://www.muni.org/mayor/mlpcea.cfm. Theoretical savings are as much as $218 million over ten years. See also, Michael F. Sheehan, "Principles for Valuing a Municipal Distribution Utility in 1998," Osterberg & Sheehan, Scappoose, Oregon, May, 1998.

erode.[200] There were 878 rural telephone co-ops in 1980, but only 272 today.[201] Over the same time period, the number of electric co-ops has only declined from 1,020 to 930 because electric monopolies remain robust.

Right-sizing co-ops also means right-sizing members' bills. Most co-ops have experimented with other lines of business than electricity, with mixed success.[202] This failure is ironic because conservation directly benefits members, and in the amount of the members' own choosing. Every co-op should be mandated to promote conservation, and in ways that have proven to be effective.[203]

Of course conservation will also slow the growth of co-op sales. Co-op managers have been paid to boost consumption for so long[204] that they have naturally been slow to innovate with variable-price electricity, time-of-day meters, remote-monitoring of meters, and prepaid electricity cards. These and other demand-management techniques should be promoted by co-ops in order to put members first. Once co-ops have right-sized

[200] Deregulation of the telecommunications industry fostered the formation of the competitive local exchange industry (CLECs) comprised of smaller telephone companies which have grown regionally to positions of strength. Not all have been successful. The Forstman-Little McLeod experience was particularly costly.
[201] 2005 TELECOMMUNICATIONS STATISTICAL REPORT.
[202] NRECA slide show.
[203] NRECA survey data of 88% of co-ops offering renewable energy, 77% offering energy-savings audits, etc. do not reveal how effective these offers have been. More persuasive are the 49% of co-ops that offer financial incentives for customer efficiency/conservation, or the 37% that have direct control over some members' appliances, or the 40% that have advanced metering devices. Still, even these numbers do not reveal how much electricity waste is reduced. Getting all utilities to share best practices should enable co-ops to regain their credibility as the most consumer-friendly of the power companies in regard to conservation.
[204] In the same Annual Report, conservation is relegated to the last two pages of the Report, despite the phrase, "Co-ops aggressively promote energy efficiency and conservation."

members' bills, they should be allowed to continue venturing into other lines of business that are appropriate for co-ops.

Co-ops should be extremely wary of the effort to take advantage of their strong balance sheets to finance a particular energy industry's new power generation.[205] Co-ops lack the expertise to make such a commitment to coal or any other fuel, and their capital should be for the benefit of members, not energy companies. Co-ops overbuilt power plants in the 1970s, resulting in wasted capacity and bankrupt co-ops. Co-ops are unusually dependent on coal-fired steam plants, relying on them for 80% of their power versus 50% for IOUs. As a result, co-op decisions about new generation capacity may be biased toward coal. Some investment in coal-fired steam plants may be necessary, but co-ops are not able to decide such questions without thorough research and the approval of their members, after careful consideration of the environmental impact.

Governance: Empowering Members

Once co-ops are large enough to be efficient, and focused on serving their members needs, co-op members need to be empowered to protect their own interests. Empowerment is better than rate regulation by state utility commissions because it enhances "The Co-op Difference." Empowerment begins with requiring all co-ops to disclose each member's equity stake at least annually, along with ways for members to access their capital credits. This would reinforce NRECA's own advice, and at low cost

since co-ops already have the software and monthly contact with customers to educate members quickly. In addition, a simple grading system, such as A through F, should be developed so that all members can easily evaluate their co-op's relative performance. To further empower members, Congress should pre-empt the portions of state electric-co-op laws relating to proxy voting and quorum requirements so that members can better defend their own interests at annual meetings. These changes should be sufficient for all but the largest of co-ops which, due to their similarity to IOUs, must do more to protect member interests.

The risk of the disclosure approach is that many newer co-op members would still not consider their ownership stake large enough to be worth the effort to process co-op information, and many older members, even with large accounts, might remain passive. For this reason, at least for larger co-ops, capital credits should be made "securities" under the federal securities laws.[206] Alert judges should already realize they are securities, but it will probably be necessary for Congress to clarify the 1933 Securities Act which fudged the issue. Trial lawyers would jump at the chance to seek treble

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[205] The NRECA 2006 Annual Report reads like coal industry promotion, particularly the opening letters from the Chairman and CEO.

[206] "The larger the co-op, the more it looks like a public company. So the more you would expect it to follow public company norms in terms of its governance." Charles Elson, John L. Weinberg Center for Corporate Governance, University of Delaware, as quoted in Claudia Grisales, *Pederanales co-op changes leaders and bylaws, but members still locked out*, AUSTIN AMERICAN-STATESMAN, Jan. 6, 2008. For discussions of agricultural co-operatives and securities, see Frank A. Taylor, *Are Financial Instruments Issued by Agricultural Co-operatives Securities?: A Framework for Analysis*, 5 DRAKE JOURNAL OF AGRICULTURAL LAW 171 (Spring, 2000) and Kathryn J. Sedo, *The Application of Securities Laws to Co-operatives: A Call for Equal Treatment for Nonagricultural Co-operatives*, 46 DRAKE LAW REVIEW 259 (1997). See also William E. Van Valkenberg and Robert G. Bergquist, *Securities Law Update: Reves v. Ernst & Young*, THE CO-OPERATIVE ACCOUNTANT, Summer, 1990, p. 36. Reves held that demand notes issued by a co-operative were securities under federal law.

damages under the securities law for co-op abuses of member rights. Litigation would lead to instant co-op reforms, but attorney fees and court costs would be high.

Fortunately, an elegant and voluntary means of empowerment exists that also minimizes litigation costs. Informed co-op members should vote to take their co-op public on the NASDAQ stock exchange.[207] Although IPOs sound radical to incumbent co-op managers, this way of unlocking shareholder value is commonplace in the business world. Unfortunately, because so few co-op managers are familiar with the process, it looks more threatening than it is. Essentially, members would be choosing to turn their capital credits into securities that are traded on the stock exchange.

The widespread conversion of mutual insurance companies, savings and loan associations, and credit unions to stock companies shows that member rights can be enhanced by floating shares in public markets.[208] Of course, when poorly handled, such conversions can disproportionately benefit insiders. Nevertheless, this abuse can be avoided if careful attention paid to the terms of the offering. The key benefit of conversions is that member's ownership becomes instantly visible, liquid, and priced to the market every day. No member would have to sell their stock after such an offering; in a well-run co-op, no one would want to. Voluntary conversion allows members to decide what is best for themselves and their property, ending the paternalism of today's co-ops.

[207] The author participated as an investment banker in one such effort to take a telephone co-operative public in 2000. See Prospectus, DTC Communications, Jan. 11, 2000. Www.sec.gov.
[208] See Weisbrod, *supra*, pp. 129-150.

Subsidies: Means-Testing Co-ops

The final co-op reform is the most obvious and overdue. If federal aid were restricted to the co-ops that truly needed help, and suburban co-ops were left to fend for themselves, federal taxpayers could save money and improved co-op management might result.[209] Means-testing co-ops will be bitterly resisted by co-op managers, but it is doubtful that co-op members themselves would be so critical. Most Americans claim to be opposed to government waste; they know it doesn't make sense to subsidize utilities that serve the wealthy counties, whether they are IOUs, munis, or co-ops. Removing federal subsidies for co-ops would strengthen the argument for dismantling the larger subsidies for IOUs and munis. Selective removal could also be an effective enforcement tool against co-ops that refused to become more efficient or member-friendly.

A tougher question involves the possibility of removing tax-favored status from wealthy co-ops that are otherwise indistinguishable from IOUs. Many co-op managers view tax-favored status as a permanent entitlement instead of a special incentive to provide public goods. Revising co-op tax status for prosperous co-ops would also allow legislators to consider removing the tax subsidies from other power companies.

Conclusion

[209] The Bush Administration has proposed that each co-op recertify its rural status before new loans can be made to it by RUS. Office of Management and Budget, APPENDIX TO THE BUDGET OF THE UNITED STATES, FISCAL YEAR 2008, January, 2007, p. 146.

Too many electric co-ops have turned away from being the most exciting, pro-consumer organizations in America to being anti-consumer. Co-ops should return to their roots voluntarily, but a legislative push is probably necessary. Carefully considered, member-friendly reforms are long overdue in order to protect the rights of the co-ops' legal owners, which probably include receiving refunds of $3 billion to $9 billion of capital credits. Also, the conservation and environmental impact of co-op decision-making must be considered. It's time for members to take back their property, and their co-ops, for the good of themselves and their country.

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