United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs, Committee on Government Reform, House of Representatives

June 2004

RURAL UTILITIES SERVICE

Opportunities to Better Target Assistance to Rural Areas and Avoid Unnecessary Financial Risk

GAO
Accountability ★ Integrity ★ Reliability

GAO-04-647

June 2004

RURAL UTILITIES SERVICE

Opportunities to Better Target Assistance to Rural Areas and Avoid Unnecessary Financial Risk

GAO
Accountability•Integrity•Reliability

Highlights

Highlights of GAO-04-647, a report to the Chairman, Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs, House Committee on Government Reform

Why GAO Did This Study

The Agriculture Department's Rural Utilities Service (RUS) makes loans and provides loan guarantees to improve electric service to rural areas. Beyond guaranteeing loans, under a yet-to-be-implemented provision of the 2002 Farm Bill, RUS is also to guarantee the bonds and notes that lenders use to raise funds for making loans for electric and telecommunications services. Fees on these latter guarantees are to be used for funding rural economic development loans and grants. GAO was asked to examine (1) the extent to which RUS' borrowers provide electricity service to nonrural areas and (2) the potential financial risk to taxpayers and amount of loans and grants that the guarantee fees will fund. GAO also identified an alternative for funding rural economic development.

What GAO Recommends

To better target RUS' lending, Congress may wish to consider specifying that the rural area criterion apply to subsequent loans. To provide added funding for rural economic development while avoiding risk, Congress may wish to consider adding a small fee on electricity and telecommunication loans, and repealing the debt guarantee provision. USDA said that Congress has been aware of its lending practices but has not changed them, and that its budget proposes borrowers recertify they serve rural areas; it did not comment on GAO's rural development funding suggestions.

www.gao.gov/cgi-bin/getrpt?GAO-04-647.

To view the full product, including the scope and methodology, click on the link above.
For more information, contact Larry Dyckman, 202-512-3841, dyckmanl@gao.gov.

What GAO Found

While the Rural Electrification Act authorizes RUS' lending only in rural areas, borrowers that receive RUS loans and loan guarantees serve not only rural areas but also highly populated metropolitan areas. This condition stems from RUS' loan approval practices. RUS requires that borrowers serve rural areas when they apply for their first loans, but it approves subsequent loans without applying this criterion. Thus, RUS applies a "once a borrower, always a borrower" standard. Since the 1930s when the program began, substantial population growth has occurred in areas served by many RUS borrowers; 187 of the counties in which RUS borrowers provide service are in metropolitan areas with populations of 1 million or more. For example, three borrowers that received over $400 million in loans in fiscal years 1999 through 2003 distribute electricity in the immediate vicinity of Atlanta, Georgia. In contrast, about 24 percent of the counties served by RUS borrowers are completely rural, while the remainder have a mix of rural and urban populations.

RUS estimates, in a worst-case scenario, that the requirement to guarantee lenders' debt could lead to taxpayer losses of $1.5 billion—and GAO estimated that in return for this risk, fees on the guarantees would add about $15 million per year in rural economic development loans and grants. RUS officials believe that while risks are involved, losses are unlikely given the past stability of both the electricity market and the lender that might receive the guarantees. Only one lender is both qualified and interested in obtaining these guarantees. According to financial rating services, that lender is well-regarded, but worked through financial concerns in 2002 and 2003, and faces longer-term risks associated with the changes taking place in the electricity and telecommunications markets that it serves. Recognizing the risks of guaranteeing this lender's debt, RUS proposed certain risk mitigation requirements, such as a reserve against losses. However, the lender's officials have stated that RUS' proposed requirements would make the program unattractive.

GAO identified an alternative with no additional taxpayer risk to add funds for rural economic development loans and grants. If RUS were authorized to charge borrowers a small loan-origination fee of one-fourth of 1 percent on loans it expects to make and guarantee in fiscal year 2005, $24 million in rural economic development loans and grants might be made available. This amount is almost equal to the level provided by USDA's 2005 budget request for rural economic development loans and grants, and would likely have a minimal cost impact on customers of distribution borrowers. This alternative would not include guarantees of lenders' debt. Furthermore, the lender expected to use the guarantees has indicated that, even without such guarantees, it expects to continue being very successful at accessing capital for lending.

Contents

Abbreviations

CFC	National Rural Utilities Cooperative Finance Corporation
GAO	General Accounting Office
RE Act	Rural Electrification Act of 1936, as amended
RUS	Rural Utilities Service
USDA	U.S. Department of Agriculture
2002 Farm Bill	Farm Security and Rural Investment Act of 2002

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

United States General Accounting Office
Washington, DC 20548

June 18, 2004

The Honorable Doug Ose
Chairman, Subcommittee on Energy Policy,
Natural Resources and Regulatory Affairs
Committee on Government Reform
House of Representatives

Dear Mr. Chairman:

The U.S. Department of Agriculture's (USDA) Rural Utilities Service (RUS) has rapidly increased its lending for electricity service projects in recent years. In fiscal year 1999, RUS made loans and provided guarantees on loans made by other lenders totaling $1.6 billion, while in fiscal year 2003, RUS made and guaranteed more than twice that amount—about $4 billion. Overall, during fiscal years 1999 through 2003, RUS made or guaranteed $14.3 billion in loans for electricity service.

Under the Rural Electrification Act of 1936, as amended (the RE Act), RUS is authorized to make and guarantee such loans to furnish and improve electric service in rural areas.[1] For electricity purposes, the act states that an area is rural if it is not part of areas that the Bureau of the Census defines as urban—that is, densely populated areas having 2,500 or more inhabitants.[2] RUS requires borrowers to establish that they serve rural areas when they apply for their first loan. However, RUS' regulations and long-standing practice allow borrowers to receive subsequent loans without having to meet this test.[3] Thus, RUS applies a "once a borrower, always a borrower" standard.

[1]The RE Act (7 U.S.C. §§ 901 *et seq.*) also authorizes RUS' telecommunications program in which direct and guaranteed loans are used for furnishing and improving telephone service.

[2]In general, the Bureau of the Census historically defined urban areas as cities, villages, boroughs, or towns with 2,500 or more inhabitants. The Bureau of the Census revised the definition for the 2000 census to focus on population density within areas while retaining the population criterion of 2,500 inhabitants.

[3]RUS' regulations state that an area determined to be rural for an initial loan prior to November 1, 1993, shall continue to be considered rural, and for an initial loan made on or after November 1, 1993, RUS will rely on the Bureau of the Census' designation.

Borrowers that receive RUS loans or guarantees on loans for electricity service projects are primarily nonprofit cooperatives. Most of these borrowers are "distribution borrowers" that use the loans to construct and maintain the facilities that provide electricity to users; such borrowers received $9 billion of the $14.3 billion in loans during the period we examined. RUS also provides guarantees on loans to "power supply borrowers," which received the remainder of the $14.3 billion to finance the construction of electricity generation and transmission facilities.

The Farm Security and Rural Investment Act of 2002—commonly referred to as the 2002 Farm Bill—provides RUS with a new program responsibility that would increase funds for rural economic development loans and grants.[4] It directs RUS to guarantee payments on bonds or notes issued by cooperative or other nonprofit lenders, under certain conditions, if the proceeds of the guaranteed bonds or notes are used to make loans for the electricity or telecommunications purposes of the RE Act, which can include refinancing, but not electricity generation. A lender that receives such a guarantee would pay an annual fee of three-tenths of 1 percent on the outstanding guaranteed principal. These fees are to be used to fund rural economic development zero-interest loans and grants that are available from USDA's Rural Business-Cooperative Service, as well as to cover the subsidy costs of the guarantees. The Rural Business-Cooperative Service provides rural economic development loans and grants for financing economic development and job creation projects in rural areas, such as new business start-ups, existing business expansions, and community improvement projects. RUS has issued proposed regulations on the program and, as of mid-June 2004, was awaiting the completion of the Office of Management and Budget's review of the proposed final regulations for this program.

As we have previously reported, the federal government has had a long and successful role in contributing to the development of the utility infrastructure in the nation's rural areas. In the mid-1930s, when federal assistance for rural utilities began, most utilities served high-density areas and their service lines did not extend to farmers and other rural residents. This, however, is no longer the case, and we found that RUS lending practices can often result in loans to borrowers serving heavily populated areas, and to borrowers capable of using their own resources or of

[4] 7 U.S.C. § 940c-1, added by Section 6101 of the 2002 Farm Bill, Pub. L. No. 107-171, 116 Stat. 134, 413 (2002).

obtaining private sector loans to fund their utility projects. To address these conditions, we presented options to Congress for better targeting RUS' lending to rural areas and making its loan programs more effective and less costly.[5]

In this context, you asked us to examine (1) the extent to which RUS distribution borrowers provide electricity service to nonrural areas and (2) the potential financial risk to taxpayers of the 2002 Farm Bill requirement to guarantee lenders' debts, and the amount of rural economic development loans and grants that could be funded by fees on the guarantees. In addition, we reviewed the RE Act to determine whether there might be an alternative way to provide funds for rural economic development loans and grants with less risk. In the course of our work, we reviewed the RE Act and RUS' implementation policies, financial reports on RUS loans for fiscal years 1999 through 2003, and data on counties and metropolitan areas that the borrowers serve. We used counties served by the distribution borrowers as an indicator of areas being served by those borrowers that obtain RUS electricity loans. We also reviewed the relevant portion of the 2002 Farm Bill, the legislative record, and RUS' proposed program regulations and economic analysis of guaranteeing lenders' debt. We conducted our work from October 2003 to June 2004 in accordance with generally accepted government auditing standards. Appendix I describes the scope and methodology of our review in more detail.

Results in Brief

While the RE Act authorizes RUS to make loans to assist in the development of electric infrastructure only in rural areas, RUS borrowers serve not only rural areas but also highly populated metropolitan areas. This disparity between the act's requirement to serve rural areas and its implementation results from RUS applying its "once a borrower, always a borrower" standard, which allows borrowers to continuously receive RUS assistance regardless of the extent of population growth within their service territories. When we analyzed the areas served by the 530 distribution borrowers that received RUS loans or guarantees on loans over the 5 years of our analysis, we found that 24 percent, or 485 of the 1,988 counties served by these borrowers, are classified as being

[5] U.S. General Accounting Office, *Rural Utilities Service: Opportunities to Operate Electricity and Telecommunications Loan Programs More Effectively*, GAO/RCED-98-42 (Washington, D.C.: January1998) and U.S. General Accounting Office, *Congressional Oversight: Opportunities to Address Risks, Reduce Costs, and Improve Performance*, GAO/T-AIMD-00-96 (Washington, D.C.: February 2000).

completely rural or having only nominal urban populations. In contrast, 29 percent, or 581 of the counties, are classified as being in metropolitan areas; and of these, 187, or 9 percent of the 1,988 counties, are in metropolitan areas with populations of 1 million or more. For example, loans were made to cooperatives that provide electricity in suburban Atlanta, Georgia, and in the vicinity of Washington, D.C. Three cooperatives that provide service in the immediate vicinity of Atlanta received a total of more than $400 million in loans during this period, and one borrower in the Washington, D.C., area received over $25 million in loans.

The 2002 Farm Bill requirement to guarantee lenders' debts could lead in a worst-case scenario to taxpayer losses of $1.5 billion, according to RUS' estimate. In return, fees on the guarantees could, we estimate, provide only about $15 million annually in rural economic development loans and grants. RUS based its estimate of maximum potential losses on the assumption that it would guarantee $3 billion and recover at least one half of that amount if the lender defaulted. RUS officials believe that such losses are unlikely given the past stability of both the electricity market and the one current lender that might receive the guarantees. That lender is the National Rural Utilities Cooperative Finance Corporation (CFC)—a privately owned cooperative lender, which is highly rated and has had a favorable loan history going back over 30 years. However, in 2002 and 2003 three financial rating services expressed concerns about certain financial weaknesses in its portfolio. These services also noted that CFC faces some investment risks associated with the volatility of natural gas prices, competition among adjoining electric utility systems, and competition in the telecommunications industry. In recognition of the risks of guaranteeing lenders' debt, RUS has proposed to add certain risk mitigation requirements, such as the establishment of a reserve against losses, as conditions for obtaining the guarantees. In response, CFC officials stated that CFC does not need the guarantees to secure capital and that the proposed requirements would make the guarantees unworkable for them.

We identified an alternative way to raise funds for the Rural Business-Cooperative Service's rural economic development program that avoids the additional risks involved in providing guarantees on lenders' debt, in the event that the lender debt guarantee requirement is not implemented. If RUS started charging borrowers a loan-origination fee of, for example, 25 basis points (one-fourth of 1 percent) on loans made and guaranteed in fiscal year 2005, there is the potential to fund an additional $24 million in rural economic development loans and grants. This program level, which is more than the level of loans and grants that would result under the new guarantee program, is almost equal to the budget level that the Rural Business-Cooperative Service requested for 2005. Adopting this alternative would require changing the RE Act, which states that RUS is not allowed to charge a loan-origination fee on its electricity or telecommunications loans. Such a fee, which is consistent with fees charged on some other USDA loans, would likely have a minimal effect on many of the customers of RUS distribution borrowers. RUS officials agreed that this alternative would be a feasible way to fund rural economic development loans and grants. The alternative would not include guarantees of debt for CFC. Moreover, CFC officials said that they have been and expect to continue to be very successful at securing capital for lending to rural utilities, even without such guarantees.

To better target RUS' lending to borrowers serving rural areas, Congress could consider specifying that the criterion defining rural areas applies to both initial and subsequent loans. In addition, to provide additional funds for rural economic development loans and grants without risk to taxpayers, Congress could consider authorizing a small loan-origination fee on RUS' electricity and telecommunications loans while repealing the provision in the RE Act to guarantee the debt of lenders.

In commenting on a draft of this report, USDA did not express agreement or disagreement with our matters for congressional consideration. USDA stated that Congress has not accepted previous recommendations made by us and others to address its practice of lending to borrowers once an initial borrowing relationship was established. However, USDA noted that the President's budget contains a proposal that borrowers recertify they serve rural areas, not urban or suburban areas. We believe that this proposal may provide a starting point for improving the focus of this program. USDA also said that our report did not provide an accurate picture of the extent to which RUS borrowers serve consumers who are not in rural areas, and disagreed with our use of the Economic Research Service's county classification system in performing our analysis. We believe that our analyses provide insights into areas being served by RUS borrowers, and that our use of the Economic Research Service's classification system is reasonable. Our purpose was to describe the characteristics of areas served by RUS electricity distribution borrowers, and the Economic Research Service's classification system is useful for that purpose. Furthermore, the population has increased in many areas served by RUS distribution borrowers that originally qualified for loans under the requirement that they serve sparsely populated rural areas. Also, during our review, RUS officials agreed that many of its borrowers would no longer meet the RE Act population test for service to rural areas if that criterion were applied.

USDA asked that the report be revised to distinguish between criticism of the legislation authorizing the new guarantee program and RUS' efforts to implement the program. In our view, our report supports the purpose of the legislation and does not criticize RUS' implementation; it provides an alternative for funding rural economic development that avoids risk. Our report describes the results of RUS' economic analyses of the legislation, and states factually that RUS' economic analysis did not include a discussion of risks facing CFC in the electricity and telecommunications markets. Our report also describes RUS' proposals to address the risks involved in guaranteeing lenders' debts.

Background

In 1935, the Rural Electrification Administration was created by executive order to make loans to electrify rural America. RUS was established by the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 to replace this agency and now administers the electricity program.[6] It is located in USDA's Rural Development mission area.[7]

RUS' loans for electricity purposes are made primarily to nonprofit cooperatives. Cooperatives are organizations owned by their customers and operated for the benefit of those using their services. The customers elect boards of directors responsible for policy and operations. Most RUS-financed utility systems have a two-tiered structure covering electricity distribution and power supply. Retail customers are members of the distribution cooperative that provides electricity directly to their homes and businesses. Most distribution cooperatives, in turn, are members of power supply cooperatives, which generate and transmit electricity to their members.

[6]Pub. L. No. 103-354, 108 Stat. 3221 (1994).

[7]RUS also administers USDA's other utility programs, such as the telecommunications loan and the water and waste disposal loan and grant programs. These programs define "rural" differently. A "rural area" for RUS telecommunications loans is any area not included in a city, village, or borough with a population in excess of 5,000 inhabitants. "Rural" and "rural area" for RUS' water and waste disposal loans and grants are a city, town, or unincorporated area that has a population of no more than 10,000 inhabitants.

Currently, RUS makes three types of direct loans for electricity purposes. These direct loans are (1) hardship rate loans with a 5 percent interest rate made to borrowers that have a relatively high cost of providing service, as indicated by a high average revenue per kilowatt-hour sold, and that serve customers with below-average income, or at the discretion of RUS' Administrator; (2) municipal rate loans with an interest rate tied to an index of municipal borrowing rates, resulting in interest rates ranging from 1.1 percent to 4.6 percent during the first quarter of calendar year 2004; and (3) Treasury rate loans with an interest rate matching the government's cost of money, which ranged from 1.2 percent to 4.4 percent in mid-March 2004. In addition to making direct loans, RUS places a USDA 100 percent repayment guarantee on loans made by the Treasury's Federal Financing Bank, which makes loans at an interest rate equal to the Treasury's cost of money plus one-eighth of 1 percent, as well as on loans made by CFC and by CoBank—a member bank of the Farm Credit System, which is a government-sponsored enterprise. Most borrowers seeking a loan guaranteed by RUS choose to have the loan made by the Federal Financing Bank because of lower interest rates than those available from the other lenders.

The outstanding principal owed by borrowers with RUS direct and guaranteed loans totaled $28.3 billion as of September 30, 2003: $9.5 billion in direct loans, $15.3 billion in guaranteed loans made by the Federal Financing Bank, $0.4 billion in guaranteed loans made by CFC, $0.2 billion in guaranteed loans made by CoBank, and $2.9 billion in restructured loans.[8] During fiscal years 1999 through 2003, RUS made or provided guarantees on 936 electricity loans, which totaled more than $14.3 billion.[9] Table 1 shows the level of loans for each type of electricity loan.

[8]Restructured loans are loans for which the original loan agreements have been altered, including loans that had been owed by borrowers now assumed by other utilities. The amount covers the principal and the capitalized interest owed on the loans. Also, the loan amounts in this category are not included in the other direct and guaranteed loan categories.

[9]RUS also made or guaranteed more than $2.3 billion of telecommunications loans over this 5-year period.

Table 1: Electricity Loans Made or Guaranteed by RUS to Distribution and Power Supply Borrowers, Fiscal Years 1999-2003

Dollars in millions

Loan type	Total number of loans	Total dollar amount of loans	Average dollar amount of loans
Direct:			
Hardship rate	106	$558.4	$5.3
Municipal rate	175	1,485.6	8.5
Treasury rate	166	2,400.0	14.5
Subtotal direct	**447**	**4,444.0**	9.9
Guaranteed:			
Made by the Federal Financing Bank	472	9,637.9	20.4
Made by CFC	17	262.1	15.4
Subtotal guaranteed	**489**	**9,900.0**	20.2
Total	**936**	**$14,344.0**	$15.3

Source: GAO analysis of RUS data.

Note: RUS did not make Treasury rate loans in fiscal years 1999 and 2000. Also, the agency did not provide guarantees on CFC loans in fiscal years 2002 and 2003 or on CoBank loans during this 5-year period. Distribution borrowers received 444 direct loans totaling more than $4.4 billion and 420 guaranteed loans totaling more than $4.5 billion. Power supply borrowers received 3 direct loans totaling $21.4 million and 69 guaranteed loans totaling $5.4 billion.

As we have reported in the past, RUS has had problems with some borrowers. During fiscal years 1999 through 2003, RUS wrote off more than $3.2 billion on loans to three borrowers—$3 billion and $73.2 million for two borrowers under bankruptcy liquidation and $159.3 million for a borrower with unsecured debt. Also, it wrote off $7.2 million for another borrower that had been restructured.

The Rural Business-Cooperative Service, which like RUS, is in USDA's Rural Development mission area, operates loan and grant programs that are intended to assist in the business development of the nation's rural areas and the employment of rural residents. Among these programs is the rural economic development program, which is authorized by section 313 of the RE Act, 7 U.S.C. § 940c. Under the program, the Rural Business-Cooperative Service makes direct loans to entities that have outstanding RUS electricity or telecommunications loans or to former RUS borrowers that repaid their electricity loans early at a discount. Rural economic development loans are not available to former RUS borrowers that repaid their loans with scheduled payments.

All rural economic development loans are made for relending, and the loan funds are targeted to specific projects. Rural economic development loan funds are deposited into a fund that a RUS borrower has established, and the RUS borrower then relends the money to other borrowers, which may be any public or private organization or other legal entity, for an economic development and job creation project. Such projects include new business creation, existing business expansion, community improvements, and infrastructure development. Rural economic development loan funds, however, cannot be used for certain purposes, including the RUS borrowers' electricity or telecommunications operations or a community's television system or facility, unless tied to an educational or medical project.

The Rural Business-Cooperative Service also provides rural economic development grants to RUS utility borrowers to establish revolving loan funds to promote economic development in rural areas. The revolving loan funds provide capital to nonprofit entities and municipal organizations to finance community facilities that promote job creation or education and training to enhance a marketable job skill or that extend or improve medical care.

An unusual source of funding is available for rural economic development loans and grants. The RE Act provides that RUS' electricity and telecommunications borrowers can make advance payments on their RUS loans, referred to as "cushion-of-credit" payments, and earn interest at a rate of 5 percent on the advance payments. The Rural Business-Cooperative Service is allowed to use the differential between the earnings on these advance payments and the 5 percent interest to cover the subsidy costs of rural economic development loans and the cost of rural economic development grants. During fiscal years 1999 through 2003, the Rural Business-Cooperative Service made 233 rural economic development loans, which totaled $82.5 million. Also, 117 rural economic development grants were made, which totaled $24.6 million. On average, the loan amounts were about $354,000 and the grant amounts were about $211,000. The outstanding principal owed by borrowers with rural economic development loans totaled $155.2 million as of September 30, 2003.

RUS' Electricity Loans Are Often Made to Distribution Borrowers Serving Highly Populated Metropolitan Areas

Although the RE Act requires that borrowers serve rural areas, RUS borrowers serve not only rural areas but also highly populated metropolitan areas.[10] This situation results from RUS applying its "once a borrower, always a borrower" standard, which allows borrowers to continuously receive RUS assistance regardless of the extent of population increases within their service territories. Since the electricity program began in the 1930s, substantial population growth has occurred in the areas served by many RUS borrowers. We analyzed the areas served by the 530 distribution borrowers that received RUS loans or guarantees on loans between October 1, 1998, and September 30, 2003.[11] These borrowers serve customers in part or all of 1,988 counties in 46 states, and they received 864 RUS loans or guarantees on loans during this period valued at almost $9 billion.

Overall, RUS distribution borrowers provide service in more than half the counties in the country that are classified as metropolitan. In general, these metropolitan areas contain a substantial core population, together with adjacent communities having a high degree of social and economic integration with the core. About 29 percent, or 581 of the 1,988 counties served partly or completely by RUS borrowers, are in metropolitan areas; and, in fact, 9.4 percent, or 187 of the 1,988 counties, are in metropolitan areas with populations of 1 million or more. The following examples illustrate cooperatives whose service territories include highly populated areas.

- Three cooperatives that received loans during the fiscal year 1999 through 2003 period provide electricity in the immediate vicinity of Atlanta, Georgia. These three borrowers received a total of more than $400 million of loans during this period.
- A Maryland electric distribution cooperative that serves approximately 115,000 residential customers in four counties in the vicinity of Washington, D.C., received over $25 million in loans in fiscal years 1999 and 2001. Three of these counties are in a metropolitan area with a population of more than 1 million people.

[10]This report section covers distribution borrowers but not power supply borrowers, which do not directly serve residential or business customers.

[11]For this analysis, we examined RUS data on the counties served by distribution borrowers, USDA's Economic Research Service 9-point scale that classifies counties, which is based on the Office of Management and Budget's classification of metropolitan counties, and census data on county populations.

- A Florida cooperative that serves roughly 150,000 customers in parts of five counties that are located to the north of Tampa received RUS loans in fiscal years 2000 and 2002 totaling $66 million. Four of these counties have a population of more than 100,000 residents, including two with a population of more than 300,000.

On the other hand, about 24 percent, or 485 of the 1,988 counties served by RUS borrowers are completely rural or have only nominal urban populations. The remaining counties are in nonmetropolitan areas, but with urban populations of 2,500 or more.[12] Table 2 shows the classifications of the counties being served partly or completely through RUS electricity loans.

[12]Appendix II contains additional data on RUS distribution borrowers, and examples of the urban counties they serve.

Table 2: Rural-Urban Classification of Counties in the United States and Those Served by Electric Distribution Borrowers That Received RUS Direct or Guaranteed Loans, October 1, 1998, to September 30, 2003

	Counties served by RUS distribution borrowers		Counties in the United States	
Classification categories	**Number**	**Percent of total**	**Number**	**Percent of total**
Counties in metropolitan (metro) areas:				
Counties in metro areas with population of 1 million or more	187	9.4	413	13.1
Counties in metro areas with population of 250,000 to 1 million	177	8.9	325	10.3
Counties in metro areas with population of less than 250,000	217	10.9	351	11.2
Subtotal	**581**	**29.2**	**1,089**	**34.7**
Counties in nonmetropolitan areas with an urban population of 2,500 or more:				
Urban population of 20,000 or more, adjacent to a metro area	139	7.0	218	6.9
Urban population of 20,000 or more, not adjacent to a metro area	55	2.8	105	3.3
Urban population of 2,500 to less than 20,000, adjacent to a metro area	421	21.2	609	19.4
Urban population of 2,500 to less than 20,000, not adjacent to a metro area	307	15.4	450	14.3
Subtotal	**922**	**46.4**	**1,382**	**44.0**
Counties in nonmetropolitan areas with an urban population of less than 2,500:				
Completely rural or less than 2,500 urban population, adjacent to a metro area	169	8.5	235	7.5
Completely rural or less than 2,500 urban population, not adjacent to a metro area	316	15.9	435	13.8
Subtotal	**485**	**24.4**	**670**	**21.3**
Total	**1,988**	**100.0**	**3,141**	**100.0**

Source: GAO analysis of RUS data and USDA's Economic Research Service rural-urban classification codes.

RUS officials pointed out that many metropolitan areas contain rural sections. In addition, they agreed that its borrowers now provide service to a mix of areas including rural areas and heavily populated areas, and that many of its borrowers would not meet the population criterion of the RE Act if it were applied. RUS officials also told us that they had drafted legislation consistent with the President's fiscal year 2005 budget, which would require borrowers to recertify that they are serving rural areas, rather than urban or suburban areas.

Taxpayers Face Risk of Losses in Return for Loans and Grants Estimated at about $15 Million Annually

RUS estimated that guarantees on lenders' debt under the 2002 Farm Bill provision could result in losses of up to $1.5 billion on guarantees of $3 billion, although RUS does not expect such losses. RUS officials believe that while risks are involved, losses are unlikely given the past stability of both the electricity market and the lender that might receive the guarantees. In return for taxpayers assuming the risks of guaranteeing payment on $3 billion of debt, we estimated that the fees paid on the guarantees would only fund $15 million in rural economic development loans and grants annually. The one cooperative lender that is currently qualified and interested in obtaining a guarantee on its debt generally has had a favorable financial history going back over 30 years. However, the lender faces risk associated with the electricity and telecommunications markets. Recognizing risks to taxpayers, RUS proposed to add certain risk mitigation requirements, but the lender commented that these requirements would make the guarantees unworkable.

Financial Losses Estimated by RUS. Under the debt guarantee program, taxpayers would be at risk for the value of guaranteed debts. RUS estimated this value at $3 billion in an economic analysis of the program.[13] The estimate was based on the act specification that the full guarantee level is the amount of principal owed on loans that eligible lenders had made concurrently with RUS' electricity and telecommunications loans. Although taxpayers would be at risk for the full amount, RUS estimated that in the event of a default, likely maximum losses could be as much as $1.5 billion. This maximum is based on the expectation that the government could recover at least one-half of defaulted amounts. The $3 billion amount is approximately the amount of concurrent loans that RUS has made in conjunction with CFC, the only lender currently qualified and interested in participating in the program.[14] RUS identified CoBank as the only other lender that would be eligible for the guarantees.[15] However, CoBank is part of a government-sponsored

[13]RUS' economic analysis was included with its proposed program regulations. *Guarantees for Bonds and Notes Issued for Electrification or Telephone Purposes*, 68 Fed. Reg. 75153 (to be codified at 7 C.F.R. pt. 1720) (proposed Dec. 30, 2003).

[14]CFC's principal purpose is to provide cooperative utility systems with financing to supplement RUS programs. CFC competes with CoBank of the Farm Credit System to provide lending to projects partially funded by RUS, and for projects involving cooperatives in which RUS is not a participant.

[15]The Department of the Treasury's Federal Financing Bank, which makes most electricity and telecommunications loans guaranteed by RUS, is not eligible because it is a federal entity.

enterprise, and CoBank does not need the guarantees and does not plan to participate in the program, according to CoBank officials.

Although RUS does not believe CFC will default on the guaranteed bonds or notes, there would be a subsidy cost, according to Congressional Budget Office and RUS officials.[16] However, RUS has not completed a subsidy cost estimate for the program. In addition, RUS' economic analysis did not discuss CFC's financial history, its current condition, or the risks in the electricity and telecommunication markets in which CFC operates.

Fees on Guarantees Could Provide about $15 Million Annually in Rural Economic Development Loans and Grants. We estimated that in return for the risk to taxpayers, fees on the guarantees could provide about $15 million annually of additional loans and grants through the Rural Business-Cooperative Service's rural economic development program. Our calculation is based on the $3 billion guarantee level RUS identified, the details provided in the act about the annual fees that would be paid by a lender receiving a guarantee, and the use of the funds generated by the fee. The act provides that a lender receiving a RUS guarantee would pay an annual fee of 30 basis points (three-tenths of 1 percent)[17] based on the amount of unpaid principal on the bonds or notes that are guaranteed, and that at least two-thirds of the funds collected are to be used for rural economic development loans and grants.[18] The other one-third can be used for the cost associated with providing guarantees. On the basis of a $3 billion guarantee level, 30 basis points would yield fees of $9 million, of which $6 million would be available for rural economic development loans and grants. Of this, we assumed that $4 million would be used for additional grants, which is equal to the amount of grants in the Rural Business-Cooperative Service's fiscal year 2004 budget. We assumed the remaining $2 million would be used to subsidize additional loans. Based on the fiscal year 2004 subsidy rate for the rural economic development

[16]The Federal Credit Reform Act of 1990, 2 U.S.C. §§ 661-661f, requires agencies entering into new loan guarantee commitments to first obtain budget authority to cover the "cost" of the loan program. The subsidy cost of guarantees is generally the net present value of estimated payments by the government to cover defaults and delinquencies, interest subsidies, or other payments, offset by any payments to the government, including origination and other fees, penalties, and recoveries.

[17]One basis point equals .01 percent.

[18]The fees are to establish an additional funding mechanism to be used by the Rural Business-Cooperative Service to cover the costs of rural economic development loans and grants. See S. Rep. No. 107-117, at 23 (2001); H. R. Rep. No. 107-424, at 588 (2002).

program of 18.6 percent, a $2 million level would provide about $11 million in additional rural economic development loans.

Lender That Likely Would Receive Guarantees Has Successful History but Faces Some Risks. CFC has had a solid operating record for over 30 years, a high rating, and CFC officials said that CFC does not require federal guarantees on debt to raise capital for lending. While recognizing CFC's financial strength, in February 2004, its president noted that CFC had possibly faced some of the most difficult times in its history. In early 2002, CFC's long-term debt ratings had been downgraded by three credit rating services (Moody's Investors Service, Fitch Ratings, and Standard & Poor's) and the services also rated CFC as having a negative outlook.[19] Subsequently, these services raised CFC's outlook to stable because CFC had taken various positive actions including restructuring $1 billion of loans for its largest borrower, which was emerging from bankruptcy; reducing its exposure to speculative-grade telecommunications loans; reducing its reliance on short-term debt; and increasing its loan loss reserves to $565 million.[20]

Even as the rating services raised CFC's outlook, they cautioned about certain risks. For example, one rating service stated that half of CFC's 10 largest borrowers exhibit speculative-grade characteristics. Each also expressed concern about CFC's concentration in the electricity and telecommunications markets. One service cited the probability that natural gas prices will be volatile, and another stated that cooperatives operating in service territories adjacent to lower-cost systems might eventually be forced to compete. While most cooperatives have avoided competition, CFC has a fund to help defend its member cooperatives against territorial threats. In addition, one ratings service stated that competition from wireless carriers is a longer-term threat to rural telecommunications systems. CFC officials recognized that there are business risks in CFC's loan portfolio that they continually address but said they believe the risks of the loan guarantee program are very low given CFC's stable financial history, its access to capital markets, the

[19]National Rural Utilities Cooperative Finance Corporation, *Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934, Fiscal Year Ended May 31, 2003* (Washington, D.C.: August 2003).

[20]CFC is intent on maintaining a high credit rating. For example, according to CFC's May 2003 report to the Security and Exchange Commission, bonuses are authorized for key executives if CFC improves its financial ratings.

restriction preventing lenders from using the proceeds of their guaranteed debt to fund electricity generation, and the relatively small portion of CFC's overall loan portfolio that the guarantee would cover.

In its proposed regulations, RUS included certain risk mitigation measures including requirements for a bankruptcy trust, pledges of collateral, a 5 percent limit on cash patronage refunds,[21] and the use of certain standards that apply to depository financial institutions. CFC, the National Rural Electric Cooperative Association, and others commented that these proposals would make the program unworkable, and that the only requirement authorized by the act is that the securities of the lender receiving a guarantee be investment grade. Also, CFC stated that the ratings of the nationally recognized financial ratings services should be sufficient to assure its credit quality, and that if its financial rating becomes downgraded below investment grade, then that event could reasonably trigger RUS to partially limit its distribution of patronage capital. As of mid-June 2004, RUS officials said they were awaiting the completion of the Office of Management and Budget's review of the proposed final regulations for the program.

Alternative for Funding Loans and Grants without Additional Taxpayer Risk

We developed an alternative approach that could provide funding for rural economic development loans and grants without added risk to taxpayers. Specifically, if Congress amended the RE Act to provide for RUS to charge a loan-origination fee on its direct and guaranteed electricity and telecommunications loans, and repealed the new lender debt guarantee requirement, the resulting funds from the loan-origination fee could be targeted to the rural economic development loan and grant program. Doing so would accomplish the stated purpose of the debt guarantee program—that is, to provide an alternative funding source for the Rural Business-Cooperative Service's rural economic development loans and grants—while avoiding additional risk to taxpayers.

RUS' fiscal year 2005 budget request is for slightly more than $3.1 billion in electricity and telecommunications loans, and the Rural Business-Cooperative Service's request is for $25 million in rural economic development loans and $4 million in grants. At RUS' 2005 lending level, if RUS started charging a loan-origination fee of 25 basis points (one-fourth

[21]Nonprofit lenders and RUS refer to profits as "net margins" and the distribution of profits to the cooperatives' owners as "patronage refunds."

of 1 percent), the fee could result in an additional $7.8 million in funds to support rural economic development loans and grants, which, we estimate, could amount to an additional $20.4 million in loans and $4 million in grants. In effect, such an increase would be more than an 80 percent increase in the level of rural economic development loans and a doubling in the level of rural economic development grants that the Rural Business-Cooperative Service proposes making in fiscal year 2005, recognizing that different electricity and telecommunications loan levels would result in varying amounts of funds.

The appropriate fee level would, in part, be based on amounts that are needed to fund rural economic development loans and grants. Since enactment of the 2002 Farm Bill, millions of dollars have become available for this purpose through interest earnings on the cushion-of-credit payments on loans by RUS electricity and telecommunications borrowers. While the Rural Business-Cooperative Service had $6.9 million at the start of fiscal year 2002 to cover the subsidy costs of rural economic development loans and the cost of grants, by the start of fiscal year 2004, the amount had increased to $40.2 million—roughly six times the estimated cost for the program in fiscal year 2004.

The impact of a loan-origination fee would likely be relatively minor for many of the customers of the distribution borrowers that receive RUS' loans. For example, during fiscal year 1999 through 2003, RUS made or guaranteed 864 electricity loans to distribution borrowers; 264 borrowers received one loan and 266 borrowers received more than one loan over this period. If a 25 basis point fee had been charged on these distribution loans and fully passed on to the borrowers' customers, we estimate that the average one-time cost for the customers would have been approximately $2.39.[22] Such a fee would be consistent with the fees charged on some other USDA loans. In comparison, USDA charges a loan-origination fee of 2 percent on guaranteed business and industry loans, 1 percent on guaranteed water and waste disposal loans, and 1 percent on most guaranteed farm ownership and operating loans.

Although this alternative does not provide for guarantees on CFC's debt, CFC's access to capital for financing projects would not be jeopardized.

[22] As this is an average, we recognize that differing loan amounts and customer bases would result in a higher cost for the customers of some borrowers and less for others. Funds obtained through a loan-origination fee to power supply borrowers would likely result in a slight additional cost for each customer.

CFC's history and financial reports show that CFC is capable of raising the capital required for financing projects. In CFC's 2003 annual report, CFC reported that it had about $21 billion in loans outstanding, including $16.4 billion in electricity loans and $4.9 billion in telecommunications loans. CFC stated that despite significant short-term financing risk in energy trading and power marketing, it has continued to be successful in securing long-term sources of capital. For example, CFC reported that it had sold bonds in Australia, which demonstrates its ability to raise capital in major money centers of the world. CFC also reported that just after the 2003 fiscal year ended, it had access to $3.9 billion through revolving credit lines.

We discussed the guarantee provision and our alternative option with RUS officials. RUS' Administrator and officials commented that they had originally viewed the provision to guarantee lenders' debt as unnecessary because appropriations could be made available for funding the rural economic development program. Nevertheless, they stated that they are now engaged in implementing the guarantee provision. They agreed that the alternative option we raised is consistent with the loan-origination fees USDA places on some other loans, would be a feasible way to fund rural economic development loans and grants, and would likely have a very small effect on the customers of borrowers that receive RUS loans.

Conclusions

The rural electricity program is no longer operated in a manner fully consistent with the concept of service to rural areas. RUS policies allowing loans and guarantees to be provided to borrowers whose customer base has grown significantly and that provide service in urban metropolitan areas go beyond the original intent of the program. Consequently, the program's focus on service to rural residents has been blurred, and the federal goals now being served by the program are not fully transparent. Better targeting of loans to borrowers that provide service in rural areas would result in more consistent use of RUS' funds and reduce the government's lending costs. Such targeting could be accomplished by recognizing that there have been population increases in previously rural areas and applying a population criterion to both initial and subsequent loans, thereby ensuring that lending remains focused on rural areas.

We are also concerned about the proposed guarantee of lenders' debt because it would unnecessarily increase taxpayer risk. Guarantees on lenders' debt are not needed to raise capital for lending to electricity service providers. In addition, the stated purpose of the debt guarantee program—raising funds for rural economic development loans and grants—could be accomplished through a no-risk alternative that we have identified.

Matters for Congressional Consideration

We are presenting three matters for congressional consideration. To better target RUS' lending to borrowers serving rural areas, Congress may wish to consider specifying that the program criterion for rural areas applies to both an initial loan and any subsequent loans that borrowers seek. In addition, to provide additional funds for rural economic development loans and grants without risk to taxpayers, Congress may wish to consider amending the RE Act to authorize a small loan-origination fee on RUS' electricity and telecommunication loans and direct that fees collected on such loans be used for rural economic development loans and grants, and simultaneously repeal the new lender debt guarantee requirement.

Agency Comments and Our Evaluation

We provided a draft of this report to USDA for review and comment. We received written comments from the Acting Under Secretary for Rural Development, which are presented in appendix III together with our detailed responses.

USDA did not express agreement or disagreement with our matters for congressional consideration. USDA commented that the report challenges the long-established RUS practice of determining the rural or nonrural nature of areas at the time RUS made the loan for initial service, but not doing so for subsequent loans. In this regard, USDA also said that this issue has been raised with Congress many times before, and that while Congress has revised the RE Act, it has not accepted previous recommendations from us and others to address RUS' lending practices. However, USDA pointed out that the President's budget recommends that the rural status of borrowers be recertified. According to USDA's budget summary for fiscal year 2005, RUS' borrowers would be asked to recertify that they are serving areas that are rural, rather than urban or suburban areas. In addition, RUS officials told us that they drafted legislation along these lines, but that USDA has not sent this proposal to Congress for consideration. Given this apparent recognition by USDA of the need to address RUS' lending practices, there may be an opportunity for improving the focus of RUS' program.

USDA also commented that it believes the methodology used in the report does not accurately portray the extent to which its borrowers serve consumers who are not in rural areas. USDA referred to the definition of rural in the RE Act and said it believes that any methodology used to characterize a borrower's service territory should be based directly on Bureau of the Census data as applied to the service territory maps of its borrowers. USDA also stated that our use of the Economic Research Service's county classification system is inappropriate and that the Office of Management and Budget has said that it is not correct to use statistical information about metropolitan areas for determining eligibility for federal programs. The service territory maps of the 530 distribution borrowers included in our analysis were not available at RUS; collecting these maps and applying census data to each one would have precluded us from providing a timely response to our requester. While RUS does not collect comprehensive data on the areas served by its distribution borrowers, nor maintain current service territory maps of its borrowers, RUS identified for us the counties each borrower serves. This information enabled us to use the Economic Research Service's rural-urban classification system to characterize the areas served by RUS borrowers. Also, our report makes no specific determinations about the eligibility of any RUS borrower to participate in the program. We disagree with USDA's objection to the use of the rural-urban classification method developed by the Economic Research Service. USDA's Economic Research Service classification system is based on Bureau of the Census data, and it classifies areas, including counties, by degree of rurality. According to the Economic Research Service, its system captures the diversity of rural America in ways that are meaningful for developing public policies and programs. We agree that these classifications are not the criteria of the RE Act. Our purpose, however, was to describe the characteristics of areas served by RUS electricity distribution borrowers, and the Economic Research Service's classification system is useful for that purpose. We believe our analyses, taken together, provide insight into the extent of service provided by borrowers in counties with large urban populations within metropolitan areas, which we have emphasized in our results. Furthermore, the population has grown in many areas served by RUS distribution borrowers that originally qualified for loans under the requirement that they serve sparsely populated rural areas. During our review, RUS officials agreed that many of its borrowers would no longer meet the RE Act population test for service to rural areas if that criterion were applied.

USDA also discussed the general location of places where rural residents reside and stated that the majority live in metropolitan counties. Accordingly, USDA said that the report would classify service to these consumers as evidence that a distribution borrower was serving nonrural areas. We did not use our results in this manner and our leading observation, based on several analyses and our previous reports, is that RUS distribution borrowers serve not only rural areas but also highly populated areas. At the same time, we reported that about 24 percent of the counties served by RUS distribution borrowers are completely rural or have only nominal urban populations. However, it should be recognized that, according to USDA's Economic Research Service, rural areas, particularly those rich in natural resources, have experienced economic transformation and rapid population growth, while other areas face declining job opportunity and population loss. We believe that suggestions to better target RUS lending could respond to these changed conditions.

Finally, USDA commented that it is important to recognize, and not criticize, RUS' efforts to implement the 2002 Farm Bill provision to guarantee the bonds and notes that lenders could use to raise funds for making loans for electricity and telecommunications services. USDA asked that the report be revised to distinguish between criticism of the legislation and RUS' efforts to implement it. We believe that our report properly describes RUS' efforts to implement the legislation in a factual manner and supports the purpose rather than criticizes the legislation in the 2002 Farm Bill calling for the new guarantee program or RUS' efforts to implement the legislation. It does, however, provide an alternative for funding rural economic development that avoids risk. Our report notes RUS' view that guaranteeing bonds and notes may not result in losses, although providing such guarantees would include some risks to taxpayers and, in a worst-case scenario, could result in potential losses of $1.5 billion. We stated that, recognizing the potential risks, RUS included in its proposed regulation certain risk-mitigation requirements not specified in the 2002 Farm Bill. However, we also noted that CFC commented that these proposals would make the program unworkable. In addition, we stated that RUS' economic analyses do not include a discussion of risks facing CFC in the electricity and telecommunications markets.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from the date of this letter. We will then send copies to interested congressional committees; the Secretary of Agriculture; the Administrator of RUS; the Director, Office of Management and Budget; officials at CoBank and CFC; and other interested parties. We will make copies available to others on request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please call me at (202) 512-3841. Key contributors to this report are listed in appendix IV.

Sincerely yours,

Lawrence J. Dyckman
Director, Natural Resources
and Environment

Appendix I: Objectives, Scope, and Methodology

The Chairman of the Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs, House Committee on Government Reform asked that we report to him on (1) the extent to which RUS distribution borrowers provide electricity service to nonrural areas and (2) the potential financial risk to taxpayers of the 2002 Farm Bill requirement to guarantee lenders' debts, and the amount of rural economic development loans and grants that could be funded by fees on the guarantees. In addition, we identified an alternative that could provide funds for rural economic development loans and grants.

In the overall course of our work, we reviewed the basic statutory authority for RUS programs—the Rural Electrification Act of 1936, as amended (RE Act); USDA's *Budget Explanatory Notes for Committee on Appropriations* for fiscal years 1999 through 2005; prior GAO reports; and RUS reports and publications. To provide relatively current information on RUS' electricity program, we focused on the loans RUS made, guaranteed, and wrote-off in fiscal years 1999 through 2003. We interviewed RUS officials, including the Administrator and Assistant Administrator for the electricity program. For the Rural Business-Cooperative Service's rural economic development loan and grant program, we used similar sources, including agency publications and reports, its annual financial report containing information on loans and grants made from fiscal year 1999 through 2003, the budget explanatory notes, and our prior reports. We also interviewed USDA's Deputy Administrator for the business programs. We did not verify the accuracy of the financial information contained in the Rural Business-Cooperative Service's annual financial report.

To address the extent to which RUS distribution borrowers provide electricity service to rural and nonrural areas, we obtained information about RUS' lending policies by reviewing provisions of the RE Act; RUS regulations; and our prior reports; we also interviewed RUS officials.[1] We obtained automated financial reports from RUS that covered all direct and guaranteed electricity loans made between fiscal years 1999 and 2003. We took steps to verify the accuracy of the information contained in the automated financial reports, and performed some data reliability testing and found that the data were reliable enough for our purposes. We also obtained from RUS a list of the counties served by its active electricity borrowers, which we compared to the Economic Research Service's 2003

[1]We did not include power supply borrowers in this part of our analysis because they do not directly serve retail customers.

rural-urban continuum codes. These codes classify all U.S. counties along a 9-point scale that distinguishes metropolitan counties by the population size of their metropolitan area and nonmetropolitan counties by the degree of urbanization and adjacency to a metropolitan area. The metropolitan and nonmetropolitan classifications are based on the Office of Management and Budget's June 2003 groupings. Metropolitan counties are distinguished by the population size of the metropolitan statistical area of which they are part. Nonmetropolitan counties are classified according to the aggregate size of their urban population and by whether they are adjacent to a metropolitan area. Using this information, we coded the counties where RUS' electricity borrowers that received loans between fiscal years 1999 and 2003 provide service.[2] To avoid overstating the number of counties served by RUS borrowers, we did not code the same county twice, in the event that two different borrowers served customers in the same county. We then analyzed county-level data from the 2000 census. Specifically, we analyzed the number of residents in counties that the Bureau of the Census classifies as residing in rural and urban areas. In general, the Bureau of the Census historically defined rural areas as cities, villages, boroughs, or towns with fewer than 2,500 inhabitants. The Bureau of the Census revised the definition for the 2000 census to focus on population density within areas while retaining the 2,500 population criterion. Thus, for this part of our analysis, we used counties served by the distribution borrowers as an indicator of areas being served by borrowers that obtain RUS electricity loans. We also analyzed the service area maps of selected RUS borrowers.

We also cross-referenced the loan information we obtained from RUS against data that the distribution borrowers report to the agency annually on the number of customers that they serve. We then categorized the borrowers that received loans by various incremental ranges of residential customers served. These ranges generally correspond with the population criteria for various USDA rural development programs—for example, a population of less than 2,500 for electricity loans, 10,000 or less for water and waste disposal loans and grants, and 20,000 or less for community facility loans and grants. We used the most recently available customer data at the time a loan was approved for our analysis. Thus, if a loan was approved in calendar year 2000, we used customer data as of December

[2]We did not include data on distribution borrowers serving Puerto Rico or American Samoa in this part of our analysis because the Economic Research Service does not classify counties in U.S. territories.

31, 1999. We took this approach because the agency does not collect data on the number of customers in each county that the borrowers serve. We recognize that most borrowers serve multiple areas, which could result in their having a high number of customers. However, we noted that the residential customer data are counted as individuals responsible for paying the electricity bills; a household is generally counted as one customer. Thus, the customer count data would be less than the number of inhabitants.

To address the potential financial risk to taxpayers of the 2002 Farm Bill requirement to guarantee lenders' debts, and the amount of rural economic development loans and grants that could be funded by fees on the guarantees, we reviewed the relevant portion of the act and its legislative record. During the initial portion of our review, RUS had not issued a proposed or implementing regulation. Because the Rural Business-Cooperative Service's Deputy Administrator for the business programs told us the agency had not yet developed a program-level estimate of the additional loans and grants that could be funded under the new program, we made such an estimate using RUS' estimated level of guaranteed debt and the resulting available fee proceeds, if that level were achieved, and the Rural Business-Cooperative Service's fiscal year 2004 budget figures for rural economic development loans and grants. To obtain information on RUS' efforts and plans to implement the new guarantee program, we interviewed RUS officials, including the Assistant Administrator for the electricity program. A proposed regulation was published in the *Federal Register* on December 30, 2003. We reviewed this document to determine how the agency was proposing to implement the new program and the agency's description of the program's risk, impact, and benefits. We interviewed officials of CFC and CoBank to obtain their views on the proposed new program, and reviewed financial and business reports on these entities and the electric and telecommunications industries.

To determine whether an alternative mechanism might be available to fund the rural economic development program with less risk, we analyzed RUS' fiscal year 2005 budget request for electricity and telecommunications loans and the Rural Business-Cooperative Service's request for rural economic development loans and grants to determine what level of fees would be needed to cover the costs of the Rural Business-Cooperative Service's program. For this part of our analysis, we focused on a fee level that could result in a level of funds to support rural economic development loans and grants that approximately doubles the Rural Business-Cooperative Service's fiscal year 2005 requested program levels. Moreover, we obtained from the Rural Development mission area's finance office information on the level of funds in the cushion-of-credit account and available to cover the subsidy costs of rural economic development loans and the cost of rural economic development grants.

We conducted our review from October 2003 to June 2004 in accordance with generally accepted government auditing standards.

Appendix II: Customers and Examples of Urban Counties Served by RUS Borrowers

This appendix contains two tables: table 3 provides information about the numbers of customers served by RUS distribution borrowers included in our analysis; table 4 provides information about 12 counties with substantial urban populations that are served entirely or predominately by RUS electricity borrowers. These counties are located in the vicinity of Atlanta, Georgia; Charlotte, North Carolina; Tampa, Florida; and Washington, D.C.

Table 3: Direct and Guaranteed Electricity Loans Made to Distribution Borrowers from Fiscal Years 1999 through 2003, by Range of Residential Customers Served

Dollars in millions

	Loans		Dollars		Average number of customers served	
Range of residential customers served	**Number**	**Percent of total**	**Amount**	**Percent of total**	**Residential customers**	**Nonresidential customers**
Less than 2,500	54	6.3	$90.0	1.0	1,561	369
2,500-10,000	354	41.0	1,530.1	17.1	5,724	926
10,001-20,000	211	24.4	2,184.6	24.4	14,280	1,520
20,001-50,000	195	22.6	3,401.2	38.0	30,319	3,093
50,001 or more	50	5.8	1,751.2	19.6	75,731	7,520
Total	**864**	**100.0**	**$8,957.1**	**100.0**	17,156	1,907

Source: GAO analysis of RUS data.

Note: The percentage of dollars is based on whole numbers and the totals may not add due to rounding.

Table 4: Population Profile of 12 Counties That Are Entirely or Predominantly Served by Electric Cooperatives That Received RUS Electricity Loans between Fiscal Years 1999 and 2003

County	Total population of county	Urban population of county	Rural population of county	Percent rural within county
Calvert, Maryland	74,563	40,429	34,134	46
Charles, Maryland	120,546	79,874	40,672	34
Citrus, Florida	118,085	67,791	50,294	43
Coweta, Georgia	89,215	48,586	40,629	46
Douglas, Georgia	92,174	73,467	18,707	20
Fayette, Georgia	91,263	71,391	19,872	22
Forsyth, Georgia	98,407	64,243	34,164	35
Hall, Georgia	139,277	93,066	46,211	33
Hernando, Florida	130,802	99,591	31,211	24
Pasco, Florida	344,765	293,288	51,477	15
Spalding, Georgia	58,417	34,745	23,672	41
Union, North Carolina	123,677	62,039	61,638	50

Source: GAO analysis of electricity cooperative service area maps and 2000 census data.

Appendix III: Comments from the U.S. Department of Agriculture

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

USDA

United States Department of Agriculture

Office of the Secretary
Washington, D.C. 20250

MAY 24 2004

Mr. Lawrence J. Dyckman
Director, Natural Resources and Environment
United States General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Dyckman:

Thank you for providing the United States Department of Agriculture (USDA), Rural Development, with a draft of your report on Opportunities to Better Target Assistance to Rural Areas and Avoid Unnecessary Financial Risk (Audit No. GAO-04-647). I would like to offer the following comments for your consideration and ask that a copy of this response be included in your final report.

See comment 1.

The draft report notes that the Rural Utilities Service (RUS) issued a proposed rule to implement Section 6101 (7 U.S.C. 313A) that was provided in the Farm Security and Rural Investment Act of 2002 (Pub. L. 107-171) (Farm Bill). Specifically, this section requires the Secretary to guarantee payments on bonds or notes issued by certain cooperative or nonprofit lenders that make electric and telephone loans. The draft report is critical of this legislation and suggests that Congress may wish to consider repealing it.

See comment 2.

It is important to recognize that RUS' responsibility for administering this legislation requires that the agency proceed with due diligence in accordance with the intent of Congress in its passage of the legislation. RUS has taken this responsibility seriously. We would ask that GAO's draft report be revised to distinguish between its criticism of the legislation and RUS' efforts to implement it.

RUS and National Rural Utilities Cooperative Finance Corporation (CFC) have a long history of working together

An Equal Opportunity Employer

Mr. Lawrence J. Dyckman 2

to provide credit for rural electrification and telecommunications. This relationship is grounded in Section 306 of the Rural Electrification Act of 1936, (RE Act) as amended (7 U.S.C. 901 et Seq) which explicitly mentions CFC in conferring authority to RUS to guarantee loans made by CFC for RE Act purposes. CFC is second only to RUS in providing credit for these sectors.

See comment 3.

RUS contracted for, and obtained, a sophisticated, independent empirical analysis from Bearing Point to the degree of risk of loss in the case of investment grade bonds. The Bearing Point analysis shows that the probability of incurring any loss under the 313A program is unlikely. We believe that the report should acknowledge what the data shows.

See comment 4.

See comment 5.

See comment 6.

The report also challenges the long-established RUS practice of determining the rural or non-rural nature of areas as of the time RUS made the loan for initial service. Generally speaking, this practice, which the report refers to as "once a borrower always a borrower", has meant that once an applicant has established a borrowing relationship with RUS, subsequent population growth in its service territory does not preclude eligibility for further RUS financial assistance. We note that GAO and others have brought this matter to the attention of Congress many times before. In addition to the 1998 and 1996 GAO reports cited in this latest report, the Congressional Research Service (CRS) analyzed this same issue in 1991 in CRS Report for Congress, The Rural Electrification Administration: Background and Current Issues (91-614 ENR, August 12, 1991). Although Congress has amended the RE Act several times in the intervening years, instead of accepting these recommendations, Congress has continued to support the current electric distribution program. However, the President's budget recommends that the rural status of borrowers be re-certified.

See comment 7.

We also believe that the methodology used in the report does not present an accurate picture of the extent to which RUS borrowers serve electric consumers that are not in rural areas. The RE Act defines rural as being any area not included within the boundaries of any urban area as defined by the Bureau of the Census. We believe that any methodology attempting to measure the current demographic characteristics of an RE borrower's service territory should be based directly on Bureau of the Census data. This data can be projected on to maps of borrowers' service territory to ascertain their demographics. This seems to be what was done in the case of six specific borrowers named in the report. However, different and inappropriate standards were used for characterizing the remainder of RUS borrowers. Instead the Report used techniques used by Economics Research Service (ERS) researchers and others who discuss conditions in "rural" America by referring to conditions in "nonmetropolitan" areas.

See comment 8.

Metropolitan statistical areas are defined on the basis of whole counties. Metropolitan statistical areas are defined by the Office of Management and Budget (OMB) to provide nationally consistent definitions for collecting, tabulating and publishing Federal statistics for geographic areas. OMB has expressly characterized the use of these definitions "for implementing nonstatistical programs and determining program eligibility" as being "inappropriate." (65 FR 82228) (December 27, 2000). This is because "OMB establishes and maintains these areas solely for statistical purposes." Id.

See comment 8.

When these terms are applied to the 59.1 million rural residents counted by Census 2000, the majority of rural residents lived in metro counties. (Source: Economic Research Service, USDA: "Measuring Rurality: What is Rural?"). Accordingly, it is possible for systems to serve consumers who are "rural residents" for Census 2000 and RE Act purposes even though those same consumers are classified as "metro residents" for Federal statistical purposes. Nevertheless, the report would classify service to these consumers as evidence that a distribution cooperative was serving nonrural areas. Under the county-based methodology used in the report, a system that served only a handful of consumers living in a county listed as "metro" would be considered to be a borrower serving a non-rural area regardless of the actual demographic characteristics of its service territory or the amount of infrastructure it has located in the metro county.

The report raised the issue of targeting of loan funds. We would note that targeting of loans would not reduce the Government's subsidy cost for the electric program,

Mr. Lawrence J. Dyckman 4

See comment 9.

contrary to GAO's statement on page 19 of the draft report. The fact of the matter is the electric loan program involves very little subsidy cost. For example, the President's 2005 budget includes $2.6 billion in electric loans at the subsidy cost of only $4 to $5 million. Moreover, this subsidy cost is limited to direct loans made for "hardship" and "municipal rate" purposes. The majority of the electric loan program actually operates at a negative subsidy cost.

See comment 10.

Further we would note that GAO raised the issue on targeting of the electric loan program in its 1998 report entitled Rural Utilities Service; Opportunities to Operate Electricity and Telecommunications Loan Programs More Effectively, GAO/RECD-98-42). GAO's current draft report does not provide any new information on the matter, except for citing more recent examples of where loans have been made.

See comment 11.

The report indicates that the 5 percent hardship rate program is for borrowers that serve financially distressed areas. This statement is incorrect. By Congressional mandate the 5 percent hardship rate program is limited to borrowers who meet certain rate criteria and whose members meet certain income level criteria as measured against State averages. While arguably the per capita income may tie to financially distressed areas the rate criteria does not. Specifically, Congress provided that a borrower would qualify for a hardship rate loan if it met the rate disparity and consumer income test or met the extremely high rate test. Congress also provided that a hardship rate loan could be made at the Administrator's discretion. The criteria established by Congress are as follows:

Rate Disparity Test for Hardship

A borrower meets this test if its average revenue per kWh sold is not less that 120 percent of the average revenue per kWh sold by all electric utilities in the State in which the borrower provides service, and its average residential revenue per kWh is not less than 120 percent of the average residential revenue per kWh sold by all electric utilities in the State in which the borrower provides service.

Mr. Lawrence J. Dyckman 5

Consumer Income Test

A borrower meets this test if either the average per capita income of the residents receiving electric service from the borrower is less than the average per capita income of the residents of the State in which the borrower provides service or the median household income of the residents receiving electric service from the borrower is less than the median household income of the households in the State.

Extremely High Rates Test

The Administrator shall make an insured electric loan at the hardship rate to any borrower whose residential revenue exceeds 15 cents per kWh sold.

Administrator's Discretion

The Administrator may make a hardship rate loan if, in the sole discretion of the Administrator, the borrower has experienced a severe hardship.

Thank you for this opportunity to comment on the report. If you have any questions, please contact John M. Purcell, Director, Financial Management Division at (202) 692-0080.

Sincerely,

GILBERT GONZALEZ
Acting Under Secretary
Rural Development

The following are GAO's comments on the U.S. Department of Agriculture's letter dated May 24, 2004.

GAO Comments

1. We do not criticize the legislation in the 2002 Farm Bill calling for the new guarantee program, and offer Congress an alternative for funding rural economic development loans and grants that does not provide added risk exposure to the nation's taxpayers. Our report recognizes that a key feature of the new program, as specified in the bill report of the Senate Committee on Agriculture, Nutrition, and Forestry and in the conference report, is to provide an additional funding mechanism for rural economic development loans and grants.

2. The report recognizes that RUS has taken steps to implement the new guarantee program and does not criticize the agency's actions. Moreover, we recognize in the report that RUS proposed steps to mitigate risk in the new program, including the requirements for a bankruptcy trust, pledges of collateral, a 5 percent limit on cash patronage refunds, and the use of certain standards that apply to depository financial institutions.

3. We reviewed a January 2004 Bearing Point report prepared for RUS that lays out credit subsidy rate options, which suggest some risks with the new guarantee program. This Bearing Point report does not state or otherwise show that the probability of incurring any loss under the program is unlikely; it does, however, contain various estimated subsidy rates assuming defaults. We also reviewed a December 2002 Bearing Point report prepared for RUS on credit subsidies; this report also has no statement about losses being unlikely. These two Bearing Point reports are *Guarantee Program for Bonds and Notes Issued for Electrification or Telephone Purposes*, *Credit Subsidy Input and Output Sheets for 15-Year Bond Scenarios* (January 9, 2004), and *Bond and Note Guarantee Program*, *Credit Subsidy Research Final* (December 16, 2002). In addition, our report states that RUS estimated, in the economic analysis section of its proposed program regulations, maximum potential losses at $1.5 billion, but that RUS does not expect losses to occur.

4. Contrary to USDA's assertion, we do not challenge RUS' practice of determining eligibility when a borrower first applies for a loan to provide electricity service in a rural area. In our opinion, this practice is called for and meets the provisions of the RE Act. We do question, however, RUS' practice of providing subsequent loans for service to areas that are no longer rural.

5. We agree with USDA that there has been prior reporting on electricity loans being made by RUS to borrowers that have experienced population growth in their service territories and on RUS' policy of allowing such lending. However, we have an obligation to report on the continuation of these conditions because we were specifically requested to do so. We believe it is important to highlight these conditions for Congress given the purpose of the RE Act—that is, providing loans to assist in the electricity infrastructure development of sparsely populated rural areas.

6. In discussing the results of our analyses with RUS officials, they told us that legislation had been drafted that is consistent with the President's fiscal year 2005 budget to require borrowers to recertify that they are serving rural areas. We added this statement to the report.

7. We used various methodologies to characterize the areas served by RUS distribution borrowers because the agency does not collect comprehensive data on the areas they serve. For example, RUS does not maintain up-to-date service territory maps or current population data within those service areas. We recognize that urban-rural continuum codes of USDA's Economic Research Service are not the criteria the RE Act specifies RUS use to determine program eligibility. We also acknowledge that all the metropolitan counties served by RUS electricity distribution borrowers have at least some parts that the 2000 census classifies as rural, and that many of these counties are only partially served by a RUS borrower. Our point, however, is to generally describe the characteristics of areas served by RUS electricity distribution borrowers. Moreover, our analysis of the Economic Research Service's system was one of various methodologies we used; the others were our analyses of specific borrowers serving highly populated areas, counties with substantial urban populations served by RUS' distribution borrowers, and the numbers of customers served by these borrowers. More specifically, as USDA's letter acknowledges, the report provides information on five borrowers that serve highly populated areas. In addition, table 4 in appendix II lists the total population, urban population, and rural population based on the 2000 census of 12 counties that are exclusively or predominantly served by RUS electricity distribution borrowers. This table shows conclusively that urban populations are benefiting from RUS electricity loans. Furthermore, table 3 in appendix II disaggregates RUS electricity borrowers by the number of customers served.

8. Neither the draft reviewed by USDA, nor this report, suggests that metropolitan statistical areas be used as eligibility criteria for participating in the electricity loan program. Rather, we state in appendix I of our report that we used counties served by the distribution borrowers as an indicator of areas being served by borrowers that obtain RUS electricity loans. Our purpose in providing information on the metropolitan counties served by RUS borrowers was to illustrate how some borrowers now provide service to largely populated areas, rather than providing service solely to sparsely populated rural areas.

9. We agree that the electricity loan program involves relatively little subsidy cost. Our concern with the actual and potential cost of the program stems from the fact that RUS has experienced a high level of losses in recent years. Specifically, the background section of this report notes that RUS wrote off more than $3.2 billion during fiscal years 1999 through 2003. Our 1998 report noted that RUS wrote off more than $1.7 billion during fiscal year 1994 through June 30, 1997. In addition, it is likely RUS will incur additional losses in the near future. For example, at the end of fiscal year 2003, the assets of two borrowers that owed a total of more than $22 million were being liquidated by bankruptcy trustees, and the agency's officials told us they anticipate losses.

10. We disagree. This report contains new information highlighting that loans are being made to borrowers providing service in highly populated metropolitan areas; it provides examples of specific counties in highly populated areas that are served by borrowers; and it contains a nationwide analysis of counties that are served by borrowers that obtained loans from RUS in recent years. The report also contains in appendix II updated information on loans made to borrowers that have a high number of customers.

11. We revised the report to recognize that hardship rate loans are made to borrowers that have a relatively high cost of providing service, as indicated by a high average revenue per kilowatt-hour sold, and that serve customers with below-average income, or at the discretion of RUS' Administrator. However, we note that in the current period of low interest rates, the rate charged on hardship rate loans, which is set at 5 percent, has been higher than the rates charged by RUS on its municipal rate loans and Treasury rate loans. Specifically, as the report states, the interest rate on municipal rate loans ranged from 1.1 percent to 4.6 percent during the first quarter of calendar year 2004,

and on Treasury rate loans ranged from 1.2 percent to 4.4 percent in mid-March 2004.

Appendix IV: GAO Contacts and Staff Acknowledgments

GAO Contacts

Lawrence J. Dyckman (202) 512-3841
Charles M. Adams (202) 512-8010

Acknowledgments

In addition to the individuals named above, Jonathan C. Altshul, Vondalee R. Hunt, Cynthia C. Norris, Patrick J. Sweeney, and Amy E. Webbink made key contributions.

GAO's Mission

The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to e-mail alerts" under the "Order GAO Products" heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER