CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Peter R. Orszag, Director

June 22, 2007

Honorable David R. Obey
Chairman
Committee on Appropriations
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman,

As you requested, CBO has reviewed draft language that would authorize the Rural Utilities Service (RUS) of the Department of Agriculture to guarantee loans to electric cooperatives to construct facilities for electricity generation. Under those proposals, rural electric cooperatives that would receive a loan guarantee from RUS would have to pay a fee to the government at least equal to the estimated cost of the guarantee as defined in the Federal Credit Reform Act of 1990.

CBO estimates that implementing this program with certain safeguards could result in no significant net cost to the government. However, in the absence of such safeguards, CBO expects that RUS would probably be unable to set fees for all projects so that the net cost to the government of those loan guarantees would be zero. In that case, we estimate that the approved loan guarantees would have a credit subsidy cost to the government of at least 1 percent—or at least $20 million for the proposal to guarantee loans worth $2 billion.

Challenges in Collecting Subsidy Fees that Cover Aggregate Costs

Based on discussions with RUS and the Office of Management and Budget, CBO expects that RUS would charge most borrowers a uniform, "average" subsidy fee, largely reflecting cooperatives' current financial condition. CBO

believes that this approach would make it particularly difficult to operate the loan guarantee program at no net cost to the government.

RUS would probably set fees too low if its calculations were based on the borrowers' current financial condition. Future investments—especially in large, new coal or nuclear power plants—are likely to be more risky than the facilities the cooperatives now operate. Such plants are more capital-intensive than recent investments in natural-gas-fired plants, with capital costs accounting for 60 percent to 70 percent of the cost of their output compared to 20 percent for natural gas. The large fixed costs of coal or nuclear projects limit operators' ability to adapt to price fluctuations in national and regional energy markets. In addition, prices and production costs in the future may be less predictable than in the past because of efforts to reduce carbon emissions.[1]

RUS would also face some institutional obstacles to setting a uniform fee sufficient to offset the program's costs. The agency's statutory missions include helping to provide affordable electricity and promoting economic development in rural areas. RUS might be concerned that high subsidy fees would have a negative effect on cooperatives and their customers. Given the uncertainty surrounding subsidy estimates, RUS might try to avoid overcharging borrowers for such costs.

In addition, a uniform rate might not accurately measure differences in the creditworthiness of other parties involved in a plant's construction, operation, or sales. For example, some cooperatives will be unable to secure the kind of fixed-price contracts for building power plants that were available in the past, which increases their risk of cost overruns during construction. Likewise, the degree of credit protection afforded by long-term sales agreements with member cooperatives may vary depending on local market pressures. The RUS program experienced multibillion dollar defaults in the 1980s despite such backing, and some of the largest losses involved projects that cooperatives owned jointly with other utilities.

Because the costs and risks of individual projects are expected to vary, by assessing a single subsidy rate, RUS would have to overcharge some borrowers and undercharge others relative to their individual risk. Borrowers

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[1] See *The Credit Impact of Climate Change*, Standard and Poors, Credit Week, May 23, 2007.

with below-average risk, however, would have to be willing to pay fees that more than offset the estimated subsidy cost of their individual projects. Some cooperatives with below-average risk might still accept federal loan guarantees despite a relatively high fee because of their historical relationship with RUS and the benefit, with a 100 percent loan guarantee, of being able to borrow directly from the Federal Financing Bank of the U.S. Treasury. (Such loans bear interest at the Treasury rate plus one-eighth of a percent). Nonetheless, with private-sector alternatives available to the least risky borrowers, cooperatives would be more likely to seek and accept federal loan guarantees in cases where the fees were too low than in cases where they were too high, thereby increasing the average risk of the final portfolio of loan guarantees.

Minimizing the Government's Costs

The government's risk (and cost) in implementing this loan guarantee program through fees paid by borrowers would be minimized if:

- The agency set the subsidy fee based on the credit risk of each individual project. As noted above, CBO expects that the financial and technical risks faced by projects proposed for RUS guarantees would vary widely and could not be captured in a standardized fee.

- The borrower obtained a credit rating for the project from a national statistical rating organization recognized by the Securities and Exchange Commission (SEC). Those organizations have the resources and expertise needed to prepare thorough evaluations of the economic and contractual risks posed by individual projects. That credit rating would only be informative if it measured the risk to the federal government, excluding the potential effect of a federal loan guarantee.

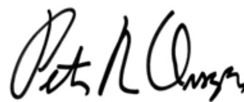
- The debt were rated AA or AAA (or their equivalent) after accounting for any credit support provided by the borrower to offset a project's credit risk, such as insurance, collateral, cash, or some other form of credit support. Amounts paid by borrowers for such actions would lower the amount of the fee paid to RUS because projects receiving AA or AAA credit ratings (or their equivalent) from those rating agencies would pose a negligible risk to the government.

- The funds used to pay the subsidy fee were not derived from federal loans or loan guarantees. Using federally backed debt to pay the fee would expose the government to a project's underlying risk without compensation for that risk.

- The government were guaranteeing less than 100 percent of the projects' costs. Reducing the amount covered would reduce the government's exposure and require a nongovernmental lender to also scrutinize the proposed project.

I hope this information is helpful to you. We would be happy to address any additional questions you might have on this topic. The CBO staff contacts are Megan Carroll and Kathleen Gramp.

Sincerely,



Peter R. Orszag
Director

cc: Honorable Jerry Lewis
Ranking Member

Identical letter sent to the Honorable John M. Spratt Jr.