

October 31, 2003

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
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Re: FSP FAS 150-c

Via E-mail

Dear Chairman Herz:

On behalf of the nation's electric cooperatives, the National Rural Electric Cooperative Association (NRECA), the USDA's Rural Utilities Service (RUS), and the National Rural Utilities Cooperative Finance Corporation (CFC) (collectively, the national organizations) express gratitude to the Board for moving to grant nonpublic entities that are not SEC registrants an additional year to implement Statement of Financial Accounting Standards No. 150 (FAS 150) as proposed in FSP FAS 150-c.

While the additional year for implementation is sincerely appreciated, the national organizations wish to express some other concerns and issues raised by FAS 150. These concerns and issues were collected from a survey of the nation's electric cooperatives regarding FAS 150. The national organizations respectfully urge the Board to consider these concerns and issues. In addition, the electric cooperative survey has proven there is a great lack of understanding and clarity throughout the industry regarding what constitutes a "mandatorily redeemable obligation," and the national organizations request a meeting with FASB staff to explain and discuss the typical electric cooperative equity redemption processes and restrictions.

NRECA is the national trade association representing the nation's approximately 930 electric cooperatives providing electricity to more than 36 million consumer-owners in 47 states. RUS is an agency of the U.S. Department of Agriculture empowered by the Rural Electrification Act of 1936, as amended, to provide financing to rural electric cooperatives for investment in utility plant. CFC is itself a cooperative that was

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organized by, is owned by, and provides primary and supplemental financing to the nation's electric cooperatives.

Of the total 930 electric cooperatives, 64 are electric generation and transmission cooperatives (G&Ts) that are owned by and sell power at wholesale to some 750 of the 866 electric distribution cooperatives. While a few electric cooperatives are SEC registrants, the overwhelming majority are not public debt issuers, but rather, have accessed substantially all of their debt financing from RUS and/or CFC. The users of a typical electric cooperative's financial statements, then, are its secured lenders – RUS and/or CFC, its members, and sometimes its major vendors.

Electric cooperatives operate on an at-cost basis, annually allocating the excess of revenues over expenses to their member-customers on the basis of each consumer's patronage. Such excess revenue – allocated to member-customers but retained by the cooperative for use in the business – is called patronage capital and constitutes the primary source of equity for the cooperative. At such time as the cooperative's board of directors determines that the cooperative is financially able to do so – and also within the contractual confines of the cooperative's mortgage and loan agreements, the board of directors may elect to redeem a portion of member-customers' patronage capital via payments of cash.

Many electric distribution cooperatives are very small business organizations. It is not uncommon for an electric distribution cooperative located in, say, the sparsely populated Great Plains or the rural southeast to serve fewer than 5,000 member-customers and employ a single office manager that also serves as the cooperative's sole accountant. Electric cooperatives are, however, required as a condition of their mortgage and loan agreements with RUS and CFC to annually submit audited financial statements prepared in accordance with Generally Accepted Accounting Principles.

Comment Regarding FSP FAS 150-c

Appreciation for One-Year Deferral in Required Implementation of FAS 150 – Electric cooperatives need the additional year proposed in FSP FAS 150-c to implement FAS 150 in order to thoroughly examine the implications of possibly reporting significant portions of their existing equity as a liability and to explore possible alternatives to their current patronage capital redemption practices if the cooperatives determine that liability presentation is too costly and/or unworkable. The national organizations, therefore, are truly grateful to the Board for moving to provide an additional year for required implementation as proposed in FSP FAS 150-c.

Comment Regarding How FAS 150 Should Be Applied by Electric Cooperatives

Discussion in the Electric Cooperative Community as to the Inapplicability of FAS 150 to Patronage Capital – Some financial professionals employed by electric cooperatives

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and their outside CPAs follow FASB issues closely and monitor the effects of FASB exposure drafts and pronouncements. For the reasons discussed below, initial analysis of FAS 150 by virtually all these accounting professionals involved with electric cooperatives indicated that patronage capital should continue to be accounted for as equity.

Member-customers of electric cooperatives own the business enterprise. In addition, the members purchase electricity from their cooperatives. Generally, the bylaws of each cooperative provide that the amounts paid for electric energy in excess of the cost of service is considered capital provided by the members. These amounts have the same legal status as if they had been paid back to the member in cash, and the member in turn furnished the cooperative a corresponding amount in equity capital. The only contractual obligation associated with this transaction is that the cooperative must maintain individual members' patronage capital accounts to show the capital provided by each member in each year. In other words, cooperative patronage capital is the accumulation of capital from revenues in excess of expenses over time. This capital is generally allocated and assigned to a cooperative's members based on patronage (purchases of goods and services) during the year.

Cooperative patronage capital is thus very similar to retained earnings of for-profit companies. The only substantive difference is that unlike in a cooperative, retained earnings of a for-profit company are not specifically allocated to each owner in the company; however, retained earnings in effect belong to each owner based on ownership percentages.

There is no contractual duty or obligation for patronage capital to be redeemed. Rather, other than the mortgage and loan agreement limitations discussed below, the cooperative board is legally authorized to exercise discretion in adopting and modifying policies regarding redemption of patronage capital. In fact, the only legal obligation associated with patronage capital redemption is upon dissolution of the cooperative. On dissolution, patronage capital is required to be redeemed after all outstanding indebtedness of the cooperative has been satisfied.

Thus, there is no constructive duty or obligation imposed on the cooperative to return capital. While many cooperatives may choose to redeem patronage capital on a regular basis and others may choose to provide for the early redemption to estates of deceased members, these patronage capital redemptions are nonetheless made at the discretion of the cooperative board. If these capital redemption policies were changed for a cooperative, the patrons would have no more recourse than a holder of common stock with a public company if its dividend policy were changed. The FASB Board has already addressed this issue in FAS 150 itself, with an example that is analogous. The following excerpt is from FAS 150:

“In contrast to mandatorily redeemable shares, shares of nonredeemable common stock do not impose on the issuer an obligation to pay dividends or to reacquire shares. Declaration of dividends is at the discretion of the issuer, as is a decision

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to reacquire the shares. Similarly, preferred stock that is not redeemable does not impose on the issuer any obligation either to repurchase the shares or to pay dividends even though failure to pay dividends may have adverse economic consequences for the issuer. Nonredeemable outstanding shares of both common and preferred stock lack an essential characteristic of a liability.”

If a for-profit company with continuing dividend payouts is not considered to have mandatorily redeemable retained earnings, it follows that a cooperative that has regular redemptions of patronage capital must not be considered to have mandatorily redeemable patronage capital. In fact, preferred stock dividends, which typically carry a specified dividend payout rate, arguably have a stronger payment obligation associated with them than do cooperative patronage redemptions.

Just as for-profit companies may distribute retained earnings to owners by paying dividends, cooperatives may return patronage capital to owners by retiring patronage capital. In both instances the payments are made at the discretion of the board of directors. The decision to return capital to owners is made using the same decision process as that used by for-profit companies – by managing the entities’ capital structure and cash flow and examining income tax ramifications.

Patronage capital distributions are not a right associated with a financial instrument, and the cooperatives’ board may elect to make changes to this policy at any time without member recourse (except, of course, through the members’ efforts to influence board policy as voting owners of the business). No obligations or promises to redeem are made in exchange for the capital. Patronage capital is also generally not a negotiable instrument that may be traded. It can be assigned only to successors in interest or successors in occupancy in all or a part of such member’s premises served by the cooperative.

Based on the criteria and examples provided in FAS 150, both cooperative patronage capital and for-profit companies’ retained earnings are not mandatorily redeemable obligations. Retained earnings are required to be settled only on liquidation. So, too, is cooperative patronage capital. Other redemptions are strictly discretionary. Like retained earnings, patronage capital must, therefore, also be classified as equity.

Finally, the point must be made that patronage capital redemptions are extremely conditional. First, as discussed above, the cooperative board retains discretion to make, or not to make, patronage capital redemptions. Second, most cooperative bylaws require the election of a number of new cooperative directors every year. The patronage redemption philosophies of a cooperative’s board, then, can and often do change over time as new board members replace old ones. Third, the terms and conditions of electric cooperative mortgages and loan agreements require that specified financial tests be met in order for a cooperative board to redeem patronage capital, or else lender approval for the redemption is required. While many cooperatives meet the specified financial tests to redeem without lender approval, others do not, and there is certainly no assurance that a cooperative meeting the tests today can continue to meet them in the future. Fourth,

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deregulation and increasing competition within the electric utility industry is likely to place negative pressure on a cooperative's ability to achieve the financial results it has in the past – when the electric utility industry operated as a monopoly. There is thus a decreased likelihood that a cooperative will be able to redeem patronage capital in the future to the extent it has been able to do so in the past.

In summary:

- a. Cooperative patronage capital is analogous in form, substance, and operation to retained earnings of a for-profit corporation. Both payment of dividends from retained earnings and redemption of patronage capital are discretionary and not mandatorily redeemable.
- b. No rights are bestowed upon patrons through the process of allocation and assignment of patronage capital. Any redemption rights are strictly at the discretion of the board.
- c. The cooperatives' boards decide how to manage (retain or redeem) the cooperatives' patronage capital. Ultimately the only required distribution of capital is on dissolution of the cooperative.
- d. Other redemptions of cooperative patronage capital are extremely conditional.

Of late, however, it has been suggested that a historical practice of equity redemptions in predictable patterns could constitute a constructive obligation to redeem. On the other hand, it has been suggested that suspension of equity redemptions for a number of years or third-party lender approval requirements could indicate that redemptions are not mandatory. We believe that these analyses are unnecessary and would only create additional uncertainty for the users of financial statements of the electric cooperatives. Comparability and consistency among entities would be lost, and significant upheaval would result among users of the financial statements. Therefore, we request a meeting with FASB staff to discuss the issues relative to patronage capital.

Comments Regarding FAS 150 from Survey of Electric Cooperatives

In order to reduce the number of comment letters regarding FSP FAS 150-c and implementation questions posed to FASB staff regarding FAS 150, the national organizations conducted a survey of FAS 150 implementation issues and concerns of electric cooperatives. A listing of the survey respondents and their business affiliations is attached. The concerns listed below are the major points expressed by electric cooperatives responding to the survey.

Detrimental Effects for Electric Cooperatives of Classifying Patronage Capital as a Liability – In the electric cooperative survey, respondents identified several potential adverse impacts on their organizations if they are required to classify a significant portion of their equity as a liability. The most named detrimental impacts are as follows:

- *Technical default under the standard electric cooperative mortgage with RUS.* Unless RUS were to revise the terms and conditions of its standard mortgage and loan agreements with electric cooperative borrowers, re-classifying significant portions of electric cooperative equity as a liability would place many electric cooperatives in technical default. Under the standard mortgage and loan agreement, the cooperative and its members could then lose control over the cooperative and its operations and be subject to other penalties.
- *Higher cost of debt financing for electric cooperatives.* With a loan portfolio comprised of electric cooperative borrowers that report lower equity cushions, CFC would need to educate Wall Street investors so they understand that this new accounting treatment does not diminish the financial strength of electric cooperatives. To the extent that this education effort is unsuccessful, CFC could likely find raising capital on Wall Street on behalf of its electric cooperative members to be more expensive. CFC, of course, would have no choice other than to pass its higher costs of borrowing on to its electric cooperative borrowers in the form of higher interest rates for electric cooperative loans. Likewise, lower electric cooperative equity levels could likely result in higher “scoring” by the Office of Management and Budget of the Federal Government’s cost to provide RUS loans to electric cooperatives.
- *More difficult for electric cooperatives to qualify for trade credit.* Many vendors serving electric cooperatives – being small businesses themselves – do not necessarily take the time to read or understand the footnotes to an electric cooperative’s financial statements. These small vendors, observing from an electric cooperative’s balance sheet that it has little reported equity, could fear the electric cooperative might default on its payables and, as a result, restrict the electric cooperative’s trade credit.
- *More difficult for electric cooperatives to substantiate credit ratings.* While the majority of the nation’s electric cooperatives do not have public credit or debt ratings, some cooperatives do. These cooperatives may rely in whole or in part on the capital markets for financing. The credit rating agencies scrutinize the financial statements of these cooperatives for evidence of credit strength. To the extent that a cooperative’s equity substantially diminishes due to an accounting rule, the cooperative will no doubt be faced with the difficult task of having to explain the reasons therefore, and could face possible downgrades due merely to the change in presentation circumstances.
- *More difficult or expensive for electric cooperatives to procure power.* The typical trading agreements used by the utility industry to provide for the purchase or sale of electric power or natural gas – particularly at the wholesale level – require a counterparty to the agreement to provide evidence of creditworthiness in order to transact business. The primary source of such demonstration of adequate credit is the counterparty’s balance sheet. Accordingly, if a cooperative has little or no equity on its balance sheet, the cooperative would be required to post significant amounts of collateral in order to procure its power supply.
- *More expensive or more difficult for electric cooperatives to hedge risks.* Many financial instruments used to hedge risks are marked to market. A

counterparty to a financial instrument is usually required to provide adequate collateral to demonstrate its ability to perform if and when payment is required. With a “weaker” balance sheet characterized by thin or no equity, an electric cooperative may likely be faced with the option of providing excessive amounts of collateral or else be forced to forego the hedging transaction.

- *Difficult for electric cooperatives to explain to their members.* Many electric cooperative members, who of course are not trained accountants, would likely find it very difficult to understand why their electric cooperative suddenly appears to be lacking an adequate an equity cushion. Likewise, if an electric cooperative revises its patronage capital redemption policies so that member equity may continue to be classified in the equity section of the balance sheet, explaining to members why the redemption policies were required to be changed – such that the redemptions are more restrictive or perhaps less predictable – could also be difficult for cooperative members to understand.

Detrimental Effects for Electric Cooperative Members of Classifying Patronage Capital as a Liability – In addition, in the survey, electric cooperatives identified potential adverse impacts for their members if they are required to classify a significant portion of their equity as a liability. The most named detrimental impacts are as follows:

- *Elimination of patronage capital redemptions to decedent estates.* Given the serious potential adverse impacts to electric cooperatives of reclassifying a significant portion of their equity as a liability, many cooperatives will likely feel forced to cease their practice of providing early redemptions to decedent estates. This unfortunate required change in cooperative redemption practice would make the task of estate administrators lengthier and more difficult and also deprive cash payments to financially needy families of cooperative members that could contribute to the deceased’s funeral expenses.
- *Increased member rates resulting from increased cooperative borrowing costs.* Cooperatives that are required to reclassify all or part of their equity to a liability account would suddenly be forced to explain the radical deterioration in their equity percentages. Cooperatives that appear to be much more highly leveraged would likely face higher borrowing costs, especially if the financing comes from traditional lending or capital market sources. These higher borrowing costs must, of course, be passed along to member-customers in the form of higher rates for the members’ electricity purchases.
- *Curtailed plant construction and new cooperative services.* Given the higher cost of debt electric cooperatives could likely face after reclassifying equity as a liability, many electric cooperatives may find themselves restricting needed capital investment in order to conserve cash.

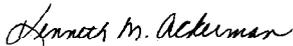
In light of these serious potential adverse impacts to electric cooperatives and their members of classifying cooperative equity as a liability, the national organizations

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believe that most electric cooperatives will likely find it necessary to take whatever steps are required to ensure that their patronage capital continues to be properly classified in the equity section of the balance sheet. Again, in order to ensure that FAS 150 is appropriately applied in the electric cooperative industry, a meeting with FASB staff is requested.

The electric cooperatives' national organizations sincerely appreciate the Board's consideration of their comments. One of the signatories below will contact FASB staff in the near future to try to arrange the requested meeting concerning electric cooperative adoption of FAS 150.

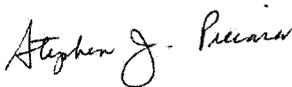
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