POLICY ESSAY

ELECTRIC CO-OPERATIVES: FROM NEW DEAL TO BAD DEAL?

REPRESENTATIVE JIM COOPER*

Most people who live or work in rural America must buy their electricity from their local co-operative, a unique and largely unregulated type of utility. Electric co-ops are owned by their customers who are called "members." This Policy Essay by Congressman Jim Cooper focuses on the primary obligation electric co-ops owe their members: "at-cost" service, i.e., the lowest feasible electric bills. To meet this obligation co-ops must provide low electric rates and timely return of equity. They must also reduce the quantity of unneeded electricity purchased. This Essay demonstrates that most distribution co-ops have a financial incentive to sell more electricity, not less. It also shows that co-ops have sought to conceal information from their members—information to which owners are entitled in other business contexts.

America's 930 electric co-operatives[1] are the sole source of electricity for homes, farms, and businesses for parts of 47 states.[2] Although 66 co-ops also generate and transmit wholesale electricity ("G&Ts"), the 864 distribution co-ops ("co-ops") simply resell and deliver electricity to retail customers across the crucial "last mile"[3] between the national electric power grid and the co-op members that ultimately use that electricity. Nationwide electrification is considered by engineers to be the greatest accomplishment of the twentieth century.[4] It is hard to imagine life without it.[5]

---

* Member, House of Representatives (D-Tenn.). B.A., University of North Carolina at Chapel Hill, 1975; B.A., Oxford University, 1977; J.D., Harvard Law School, 1980. Representative Cooper is in his third term as U.S. Representative from the 5th Congressional District of Tennessee and represents customers of two electric co-operatives. The author would like to thank James Leuschen, Tyler Allard, and Cicely Simpson for their research assistance, and Lauren Azar, Luke Froeb, and Ted Stroll for their useful comments.

[1] *See* National Rural Electric Co-operative Association (NRECA), Co-ops by the Numbers, [hereinafter Co-ops by the Numbers] http://www.nreca.org/AboutUs/Co-op101/CooperativeFacts.htm (last visited Mar. 21, 2008).

[2] Massachusetts, Connecticut, and Rhode Island are the only three states without co-ops. *Id.*

[3] This term from the telecommunications industry refers to the connection between the cable, trunk, or optic fiber lines, and homes and businesses. This connection may be a few feet or a few miles. *Cf.* TOM STANDAGE, THE VICTORIAN INTERNET 206 (1999).

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

[5] Memphis Light, Gas, & Water Div. v. Craft, 436 U.S. 1, 18 (1978) ("[U]tility service is a necessity of modern life; indeed, the discontinuance of water or heating for even short periods of time may threaten health or safety.").

FIGURE 1: MAP OF ELECTRIC CO-OP SERVICE AREAS[6]

Figure 1 Note: The shaded areas of the map are served exclusively by electric co-ops.

Despite reaching 75% of the nation's land area, co-ops serve only 5% of the population, or 17 million customers.[7] Most co-ops operate in a few rural counties where customers live far apart,[8] although an increasing number of co-ops serve populous suburbs. The median co-op has 12,000 customers.[9] Regardless of size, co-ops strive to deliver reliable, standardized electricity[10] and to quickly restore service after storms, fires, and floods. Maintaining a network of 2.4 million miles of power lines and utility poles is hard work.[11] Virtually every pole also carries the telephone lines and television cables of unaffiliated telephone co-operatives[12] or for-profit telecommunications companies.

---

[6] Co-ops by the Numbers, *supra* note 1.

[7] It is surprising that even as recently as thirty years ago, only half the nation's farmers were served by electric co-ops. This is partly due to the gradual expansion of private and municipal power companies into rural areas, and partly due to the decline in numbers of farms. RICHARD B. HEFLEBOWER, CO-OPERATIVES AND MUTUALS IN THE MARKET SYSTEM 131–32 (1980).

[8] Average co-op customer density is seven per mile, versus densities of thirty-five to forty-seven for other types of distributors. *See* Co-ops by the Numbers, *supra* note 1.

[9] *Id.*

[10] The U.S. standard for retail electricity is 120 volts, 60 Hertz, with near 100% reliability. World Electric Guide, http://www.kropla.com/electric2.htm (last visited Apr. 13, 2008).

[11] This number represents roughly half of the miles of electric lines in the U.S. *See* Co-ops by the Numbers, *supra* note 1.

[12] There were at least 227 rural telephone co-ops in 1998. *See* RURAL UTILITIES SERVICE, USDA, PUB. NO. 300-4 STATISTICAL REPORT: RURAL TELECOMMUNICATIONS BORROWERS 3 (1998).

Electric co-ops are owned by their customers, who are called "members" of the co-op due to their dual role as customer/owner.[13] The mission of co-ops is to provide access to electricity at affordable prices for every potential member in their service area, no matter how remote.[14] Co-op prices for electricity are set at the average cost of serving all residential or business customers regardless of the individual or marginal cost of service.[15] Providing service to non-members and selling commodities other than electricity to members are limited by law,[16] although co-ops find ways around the restrictions.[17]

People who live in U.S. cities or towns usually buy their electricity from either a municipally-owned power company ("muni") or a for-profit company ("investor-owned utility" or "IOU"). IOUs are much larger than co-ops; munis vary from large to extremely small based on the size of their

---

[13] *See* PUBLIC UTILITIES REPORTS, INC., ELECTRIC COOPERATIVES: ON THE THRESHOLD OF A NEW ERA 6 (1996) [hereinafter PUBLIC UTILITIES REPORTS].

[14] *See* PATRICIA LLOYD WILLIAMS, THE CFC STORY: HOW AMERICA'S RURAL ELECTRIC CO-OPERATIVES INTRODUCED WALL STREET TO MAIN STREET 16 (1995) ("[A]rea coverage [is the] the concept that any customer in an area served by a rural electric system should be able to receive service at the same cost and under the same terms and conditions as all other consumers.").

[15] This is sometimes called the "postage stamp rate" because it does not vary with distance. The rate is expressed in pennies per kilowatt-hour. *See* PUBLIC UTILITIES REPORTS, *supra* note 13, at 27. Co-ops may set different rates for different classes of service, however, so co-ops usually distinguish between residential, commercial, and industrial loads. Some co-ops add classes of service in an effort to recover their marginal cost of service, contrary to co-op principles.

[16] Co-ops risk losing their tax-exempt status if they venture too far beyond their legal purpose. The primary test for co-op tax exempt status is the "like organization" test of section 501(c)(12) of the Internal Revenue Code: "Benevolent life insurance associations of a purely local character, mutual ditch and irrigation companies, mutual or cooperative telephone companies, or *like organizations*" are exempt from federal income taxation. I.R.C. § 501(c)(12) (2006) (emphasis added). An electric co-op is a "like organization" if it receives eighty-five percent or more of its revenues by selling electricity to members on a co-operative basis. Income that does not meet the "like organization" test is called "unrelated business income" and is limited to less than 15% of co-op revenues. Rev. Rul. 67-265, 1967-2 C.B. 205. *See also* Buckeye Power, Inc. v. U.S., 38 Fed. Cl. 154, 158 (1997); BURTON A. WEISBROD, TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NON-PROFIT SECTOR 83–104 (1998).

[17] "In 2003, 93.5% of distribution cooperatives responding [to a survey] offer, or own businesses that offer, one or more services in addition to basic electric energy." NATIONAL RURAL ELECTRIC CO-OPERATIVE ASSOCIATION [NRECA] & NATIONAL RURAL UTILITIES CO-OPERATIVE FINANCE CORPORATION (CFC), CAPITAL CREDITS TASK FORCE REPORT 30 (2005) [hereinafter NRECA & CFC, TASK FORCE REPORT] (copy on file with author).

An example of co-op attempts to weaken the "like organization" test includes gaining approval to sell propane through a subsidiary although direct sales of truck-delivered propane by the co-op violate the "like organization" test. Rev. Rul. 2002-54, 2002-2 C.B. 527 (overturning prior letter rulings and banning direct propane sales by truck) and Rev. Rul. 2002-55, 2002-2 C.B. 529 (allowing co-ops to count only dividends and interest income on loans paid by subsidiaries in any line of business to count as non-member income). According to NRECA, "Rev. Rul. 2002-55 thus provides a clear means for 501(c)(12) electric co-ops to diversify into propane sales – via establishment of a subsidiary, without jeopardizing their tax-exempt status." RUSS WASSON, THE ISSUES REPORT OF THE NRECA ENERGY POLICY DEPARTMENT AND ENVIRONMENTAL UNIT, TAX, 5 (Undated).

city or town.[18] Both IOUs and munis have more flexible financial structures than co-ops[19] but usually do not compete with co-ops for customers[20] because each type of distributor has, except in rare circumstances,[21] a monopoly in its service area.

Electric co-ops have a much smaller industry share than munis or IOUs, but they still control $100 billion in assets and $31 billion in member equity.[22] Because so few members are aware of their ownership, this $31 billion may be among the largest "lost" pools of capital in America. Unlike direct shareholders of IOUs who have chosen to purchase shares in a power company, or taxpayers who automatically subsidize their city's muni, co-op members have unknowingly obtained legal title to co-op equity.[23] Unfortunately, however, most co-op members have none of the normal perquisites of ownership.

---

[18] The nation's 220 IOUs have combined assets of $700 billion, and the 2000 munis have assets of $200 billion. IOUs serve an average of thirty-five customers per mile, munis serve forty-seven per mile, and co-ops average only seven customers per mile. *See* Co-ops by the Numbers, *supra* note 1.

[19] IOUs are owned by investors or shareholders of the for-profit power company, and munis are owned by the taxpayers of the municipality. IOUs and munis have more equity capital sources than co-ops, which can only receive equity from their own members. *See* PUBLIC UTILITIES REPORTS, *supra* note 13, at 8.

[20] In the early days of electrification, when they did compete with co-ops, munis and IOUs usually only wanted to serve the largest co-op customers, not the entire co-op service area. *See* WILLIAMS, *supra* note 14, at 16 ("Territorial protection was an equally important objective, because efforts by private power companies and municipalities to take over populated areas and the more attractive rural loads threatened the ability of many co-operatives to meet area coverage goals at reasonable rates.").

[21] Municipal annexation of co-op territory is the primary source of conflict between types of distributors because many cities have grown into once-rural areas that were already served by co-ops. Extending muni electric service along with other city services such as water and sewer is a natural desire of city officials, but is fiercely resisted by co-ops that welcome greater customer density.

[22] Co-ops by the Numbers, *supra* note 1.

[23] Although members' rights to receive co-op equity do not vest until actual retirement and receipt of the capital credit's value in cash, the right to eventually receive the credit matures upon allocation of the credit on the books of the co-op. Even prior to allocation, the co-op is obligated to assign credits to members according to usage. Therefore, although credits are technically not in the member's name until retirement, there is no other legal claimant for the credits. See NATIONAL RURAL ELECTRIC CO-OPERATIVE ASSOCIATION AND NATIONAL RURAL UTILITIES CO-OPERATIVE FINANCE CORPORATION (CFC), CAPITAL CREDITS TASK FORCE REPORT 12 (legal supp. 2005) [hereinafter NRECA & CFC, LEGAL SUPPLEMENT] (on file with author).

This article focuses on the primary obligation[24] that electric co-ops owe their members: "at-cost" service, i.e., the lowest feasible electric bills.[25] For distribution co-ops, this means both low electric rates and timely return of equity.[26] Today it also means reducing electricity waste—the quantity of unneeded electricity purchased—an unimaginable problem in the early days of co-ops. There is not enough data to tell whether most of today's co-ops offer these benefits. However, this essay will demonstrate that most distribution co-ops have a financial incentive to sell more electricity, not less. It will also show that co-ops have tried to hide information from their members—information to which owners are entitled in other business contexts. Free of member scrutiny, co-op managers have often failed to serve their members' interests.

The trade association and lobbying arm of co-ops, the National Rural Electric Co-operative Association ("NRECA"), seems to be aware of many of these problems but has difficulties persuading its own membership of their importance. For example, NRECA has long admitted that many small co-ops maintain electricity rates at artificially high levels by not merging with other co-ops.[27] The NRECA has acknowledged that average co-op electric rates are 9% higher than neighboring IOUs,[28] but this average disparity does not reveal the larger disparities that exist in some areas. An estimated 350 co-ops charge at least 15% more than the closest IOU while another 175 co-ops have rates 30% higher.[29] These higher rates harm ratepayers so that small co-op managers can remain employed while members are paying more

---

[24] *See, e.g.,* Glenn English, CEO, NRECA, Remarks at the NRECA Annual Meeting 2 (Mar. 20, 2007)(on file with author) ("Basically, it's to keep the lights on and the rates down. Our success or failure will be judged on how we do this job."); *See* National Rural Electric Co-operative Association (NRECA), Electric Consumer Bill of Rights [hereinafter Electric Bill of Rights], http://nreca.org/AboutUs/Co-op101/ElectricConsumerBillofRights.htm (last visited Apr. 11, 2008) ("Consumers have a right to expect reliable, affordable, and safe electric power. Consumers have a right to expect uniform standards of electric power across the country as they travel or move.").

[25] *See* NRECA & CFC, LEGAL SUPPLEMENT, *supra* note 23, at 4 (Operating at cost is "a fundamental requirement to become and remain a "co-operative" under federal tax law and a basic requirement under most electric co-operative acts."). At-cost power has not always been the top priority of co-op managers. A 1968 survey "ranked providing reliable service as the most important of five service issues and providing dependable power supply on reasonable terms second. Low retail rates were ranked as the least important." WILLIAMS, *supra* note 14, at 31. Just as electric rates that are above cost can jeopardize co-op status, so can rates below cost because such rates are subsidized with other sources of income. WASSON, *supra* note 17, at 5-6.

[26] NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 7 ("Every electric co-operative should have a policy for annually allocating capital credits, and, subject to the board of directors' discretion and the co-operative's financial condition, annually retiring capital credits.").

[27] The NRECA's chief economist has urged co-ops to merge for many years with little success. The number of co-ops has remained relatively constant. Jim Roberts, *Things are different now*, *in* A FRAMEWORK FOR CHANGE 34 (Glenn English ed., 1996) [hereinafter FRAMEWORK].

[28] Id. at 26.

[29] *Id.*

than is necessary.[30] When co-op members receive a buyout offer from a neighboring IOU this conflict between the interests of members and managers becomes stark. As NRECA admits, "When faced with the tempting offer of a $1,000 check and a 20% reduction in electric rates, consumers naturally weigh that against the value of belonging to a co-operative."[31] Instead of merging and lowering rates, however, most co-ops have used member equity to fund anti-takeover efforts.[32]

Co-ops in some regions of the country have been doing a particularly poor job of protecting member interests. Contrary to national co-op policy,[33] Tennessee Valley Authority ("TVA")[34] co-ops have refused to refund any member equity.[35] A series of TVA Inspector General Reports concluded that dozens of distributors—both co-ops and munis—were guilty of mistreating their customers twice: first by maintaining excess reserves and then by raising electricity rates unnecessarily.[36] TVA distributors had the political clout to get the first report suppressed and the names of any offending distributors removed from both.[37] In addition, although TVA itself has sporadically pro-

[30] A co-op manager is not only the top official and highest paid co-op employee, but also the most likely to lose his or her job after a merger, because a larger co-op still only needs one top manager.

[31] FRAMEWORK, *supra* note 27, at 28. This example mirrors a buyout offer by Mississippi Power Company of Coast Electric Power Association. The offer included a 10% reduction in rates and $1,700 for each member. *See*, WILLIAMS, *supra* note 14, at 213.

[32] From 1985 to 1995, co-ops thwarted 105 takeover attempts and territorial disputes using a fund coordinated by NRECA and CFC. *See* WILLIAMS, *supra* note 14, at 214–15 ("Of the 510 member systems responding to a CFC survey, 326 indicated a willingness to contribute 5 percent of their patronage capital to the fund. Most of the respondents agreed that establishing the fund was an appropriate rural electric objective.").

[33] NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 13 n.1.

[34] The TVA was established by Congress in 1933 to improve navigation, prevent flooding, promote development, and provide electricity in rural areas. *See* Tennessee Valley Authority Act, 16 U.S.C. § 831 (2006).

[35] TVA co-ops cite an obscure paragraph in an early power purchasing contract that requires distributors to reduce electric rates instead of refunding capital credits. *See* Wesley M. Jackson, Assistant Chief – Distributor Marketing Branch, TVA, Testimony to Capital Credits Study Committee, Oct. 1, 1974, at 1 (on file with author); McCarthy v. Middle Tenn. Elec. Membership Corp., 466 F.3d 399 (6th Cir. 2006); Naomi Snyder, *Should Electric Co-ops Give Customers a Refund?*, THE (NASHVILLE) TENNESSEAN, Apr. 11, 2004, at 1A [hereinafter Snyder] (quoting Mike Bash, the CFO of the Minnesota electric co-op Connexus Energy, calling TVA co-op practice "obscene and inappropriate").

[36] *See* OFFICE OF THE INSPECTOR GEN., TENN. VALLEY AUTH., REVIEW OF TVA'S ROLE AS A RATE REGULATOR (2006) (Inspection No. 2005-5221). *See also* OFFICE OF THE INSPECTOR GEN., TENN. VALLEY AUTH., DISTRIBUTORS' SURPLUS CASH AND INVESTMENTS (1994) (Audit No. 92-0540).

[37] *See* Memorandum by William L. Hinshaw, II, Inspector General, Tenn. Valley Auth. 1 (Dec. 1, 1992) (Office of the Inspector Gen. File No. 92-0540) ("We recognized that our . . . 'final report,' would cause problems . . . ; therefore, we elected to not identify the distributors by name, but rather by number . . . . [W]e also recognized the fact that this information could not be withheld under FOIA [Freedom of Information Act], or for that matter from an inquiring Congress . . . . After discussing the audit with the Chairman [of TVA] . . . I decided it would be in TVA's best interest to reclassify the report as a draft. By doing so, it would preclude shrill media attention focused on one issue—cash position—and this would obscure more comprehensive efforts which are currently underway to deal with this complex issue."). *See also, e.g.*, OFFICE OF THE INSPECTOR GEN., TENN. VALLEY AUTH., REVIEW OF TVA'S ROLE

moted energy conservation,[38] most TVA co-ops have been unenthusiastic about educating ratepayers about ways to reduce their electric bills.[39] After seventy years of public power at both the wholesale and retail level, Tennessee leads the nation in per capita residential electricity consumption.[40]

There is anecdotal evidence of co-op abuse in other parts of the United States. An Alabama co-op failed to hold elections for board members for 38 years.[41] A suburban Atlanta co-op turned over its entire operation to a for-profit subsidiary that diversified into "pest control, mortgages, consulting, a customer call center, staffing, security systems, natural gas and another co-op in South Carolina."[42] A suburban Fort Worth co-op borrowed a billion dollars to buy a golf course, Westin hotel, and shopping mall—then declared bankruptcy.[43] Another Texas co-op has paid its board chairman almost $200,000 a year despite his ignorance of basic co-op information.[44]

As embarrassing as these examples are, co-ops have even greater potential for mismanagement and self-dealing. Unclaimed millions of dollars of co-op equity can flood local banks, brokerages, and car dealerships[45], particularly when controlled by overlapping boards of directors. Employees can be

---

AS A RATE REGULATOR, *supra* note 36, at 7 ("[T]he normal range for cash ratios is five to eight percent . . . . We . . . identified 50 distributors with cash ratios ranging from 12.5 percent to in excess of 50 percent . . . . Thirty-two of the 50 distributors had rate increases in FY 2006."). The offending distributors are never identified in the report.

[38] In 2002, the GAO reported that other public and private utilities had "gone further than TVA in implementing demand-side management programs" to reduce peak load demands and emissions. U.S. GEN. ACCOUNTING OFFICE, PUB. NO. 02-301, AIR QUALITY: TVA PLANS TO REDUCE AIR EMISSIONS FURTHER, BUT COULD DO MORE TO REDUCE POWER DEMAND 17 (2002).

[39] According to David Lilienthal, the chairman of the TVA in the 1940s, "[I]t was necessary for the TVA Board, at the very outset, to break sharply with the ways of fixing electricity rates that . . . had been followed by the electrical industry . . . . [The] [r]ates [provided] to the ultimate user were based on the principle that people wanted to use electricity not in a niggardly way, but generously and for many new uses . . . . This, we were convinced, would be financially sound, for people would then *use so much more electricity* that the income of distributors would rise proportionately." DAVID E. LILIENTHAL, TVA – DEMOCRACY ON THE MARCH 22–23 (1944) (emphasis added).

[40] *See* Energy Information Administration, State Energy Profiles, http://tonto.eia.doe.gov/state/index.cfm (last visited Apr. 4, 2008).

[41] *See* Margaret Newkirk, *Power to the People? Members Rebelled; Co-op Changed*, ATLANTA J.-CONST., Aug. 20, 2007, at A5.

[42] Margaret Newkirk, *From Co-op to Conglomerate*, ATLANTA J.-CONST., Aug. 19, 2007, at 1A, 3.

[43] *See* Steven Mufson, *Defaults Plague Little-Known Lender*, WASH. POST, Apr. 30, 2007, at D1.

[44] *See* Claudia Grisales, *Testimony Shows How Co-op Operates at Top*, AUSTIN AM.-STATESMAN, Dec. 9, 2007, at A1; Claudia Grisales, *General Manager is Firmly in Control, Co-op Workers* Say, AUSTIN AM.-STATESMAN, Dec. 9, 2007, at A8.

[45] *See* Roberta Aronson et al., *Governance and Accountability in Today's Business Climate: How Do Electric Co-operatives Measure Up?* MGMT. Q. at 2, 31 (2003) ("A conflict of interest can arise under a variety of scenarios . . . . [One] example is a situation in which the board is asked to approve a substantial purchase for fleet vehicles and one director is a close relative of the automotive dealer from which the co-op is considering purchasing its vehicles.").

paid while doing no work.[46] Managers can easily become more concerned with providing benefits to insiders than to ratepayers, especially if ratepayers are not looking.[47] Furthermore, co-op insiders have funded a major political action committee to promote their interests.[48]

While greater regulation could make this sort of misbehavior rare, co-ops are lightly regulated at both the federal[49] and state[50] level. Co-ops often deny that they are "utilities" in order to avoid regulation[51] and to lay claim to a broader mission.[52] State utility commissions usually do not set co-op rates but can settle disagreements about co-op service areas and other technical matters.[53]

---

[46] *See* Claudia Grisales, *Pedernales Keeps Paying When Some Are Away from Job*, Austin Am.-Statesman, Jan. 6, 2008, at A10.

[47] For example, the retiring General Manager of Pedernales Electric Co-operative, Bennie Fuelberg, obtained a $2 million deferred compensation package from the co-op without disclosing it to members of the co-op. Claudia Grisales, *Testimony Shows How Co-op Operates at Top*, Austin Am.-Statesman, Dec. 9, 2007, at A1.

[48] NRECA's political action committee has contributed $1.4 million to federal and state politicians in recent election cycles. Steven Mufson, *Defaults Plague Little-Known Lender*, Wash. Post, Apr. 30, 2007, at D1. The Center for Responsive Politics ranks NRECA as the sixty-fifth largest donor in American politics from 1989 to 2006, with contributions of $9.9 million. *See* Alicia Malone, *Numbers Show Unions Favor Dems with Political Contributions*, Targeted News Service., Oct. 4, 2007, at 3.

[49] The Federal Energy Regulatory Commission regulates transmission of electric power, not retail distribution by co-ops. "Under the Federal Power Act, for example, electric cooperatives with outstanding financing from Rural Utilities Service (RUS) are not subject to the full authority of the Federal Energy Regulatory Commission (FERC)." Jay Morrison et al., NRECA Legal Reporting Service, The Role of the Co-op Board as Regulator 2 (Mar. 2004) (unpublished editorial, on file with author). *See, e.g.*, City of Paris v. Federal Power Commission, 399 F.2d 983, 985 (D.C. Cir. 1968) ("REA-financed cooperatives as presently administered and financed are not government instrumentalities under Section 201(f) [of the Federal Power Act].").

The Securities and Exchange Commission does not regulate most co-ops despite the resemblance of capital credits to securities. *See* 15 U.S.C. §77b(1) (2006). For a determination of whether co-op membership interests are "investment contracts" or "certificate[s] of interest or participation in a profit-sharing agreement[,]" see United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851–52 (1975).

[50] NRECA claims that "[c]o-operatives in 43 states are subject to some form of state regulation, including 24 states that exercise some degree of statutory authority over rates." NRECA & CFC, Task Force Report, *supra* note 17, at 61. A look at NRECA's own table summarizing state enabling acts, however, shows that this claim is exaggerated. *See* Nreca, State Regulation of Electric Co-ops Survey Compilations, (2007) (on file with author). An analysis of that table indicates that only 13 states allow regulation of co-op rates, and that only 7 of those states regulate co-op rates similarly to IOUs. For a history of how co-ops stopped or streamlined regulation in several states, see Williams, *supra* note 14, at 186–89.

[51] *See* Roger D. Colton, The Regulation of Rural Electric Co-operatives 19–25 (1993) (discussing the history of co-ops' exemption from state utility commission regulation, including the argument that co-ops are not utilities).

[52] Williams, *supra* note 14, at 201 ("Co-operatives were recognizing the fact that they weren't electric utilities. They were social organizations providing electric service . . . . Our job was to make sure we were giving them the tools that they would need to fulfill their social purpose."). In fact, the new bank that would finance much of the growth of the co-ops, the CFC, only received tax exempt status from the IRS due to its "social welfare purpose." *See id.* at 65.

[53] Only seven states (Arizona, Hawaii, Louisiana, Maine, Maryland, New York, and Vermont) allow full regulation of co-op rates. Six (Arkansas, Kentucky, Michigan, New Mexico,

The U.S. Department of Agriculture's Rural Utilities Service ("RUS")[54] has general oversight powers over co-ops that still borrow from it,[55] but it is more cheerleader than critic. RUS actively promotes co-ops by offering engineering, accounting, and marketing advice.[56] The RUS received $3.89 billion in annual appropriations in 2006, or an average of $4.3 million per co-op.[57] According to NRECA, this support is much less generous to co-ops than the federal tax code is to munis and IOUs,[58] but co-ops are no more willing to part with it. Additionally, the RUS even delegates governmental authority to co-ops to select worthy local projects for federal grants and interest-free loans.[59] Co-ops have often failed to use this grant-making authority to benefit their local populations. One study, for example, found that co-ops "used discretionary funds to invest in businesses located in urban areas and a variety of securities and commercial paper" instead of creating jobs in rural areas.[60]

As a lender to co-ops, the RUS offers direct and government-guaranteed 35-year loans at favorable interest rates,[61] although it no longer offers the 2% loans that were available for decades. Cumulatively, the RUS and its predecessor agencies have loaned $39 billion to distribution co-ops and $52

Virginia, and West Virginia) allow streamlined or less stringent regulation than faced by IOUs, and the rest of the states either make rate regulation optional to the co-op or disallow it entirely. *See* NRECA, State Regulation of Electric Co-ops Survey Compilations, (2007) (on file with author).

[54] Rural Electrification Act of 1936, 74 Pub. L. No. 605, 49 Stat. 1363 (1936) (codified as amended at 7 U.S.C. §§ 901–18 (2006)).

[55] The RUS conditions loans and loan renewals on adherence to loan agreements requiring minimum performance ratios for co-operatives. *See* 7 C.F.R. § 1718 app. A (2003).

[56] *See* USDA, Rural Development's Electric Programs, http://www.usda.gov/rus/electric/index.htm (last visited Apr. 8, 2007).

[57] Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, Pub L. No. 109-97, 119 Stat. 2142 (2006).

[58] The NRECA claims that munis received $909 million in federal subsidies in 2005, or $55 per customer, that IOUs received $3.3 billion, or $35 per customer, and that co-ops received $2 per customer. *See* National Rural Electric Co-operative Association, Issue Spotlight: Electric Industry Taxation, http://www.nreca.org/PublicPolicy/ElectricIndustry/Taxation.htm (last visited Oct. 25, 2007). If this argument is true, then it would make sense for co-ops to use their political clout to eliminate all distributor subsidies.

[59] The name of the program is USDA's Rural Economic Development Loan and Grant Program ("REDLG"). It has funneled $330 million for such projects through co-ops. *Examining the United States Department of Agriculture's Rural Development Programs: Hearing Before the Sen. Comm. on Agriculture, Nutrition and Forestry*, 109th Cong. 3–4 (2006) [hereinafter *Examining the USDA's Rural Development Programs*] (statement of Glenn English, CEO, NRECA) (citing co-ops' ability "to work in partnership with business and community leaders for all types of economic development projects—business incubators, medical and educational facilities, water systems, emergency vehicles, value-added agricultural processing, manufacturing sites, etc.").

[60] *See* INSPECTOR GEN., USDA, RURAL UTILITIES SERVICE ELECTRICAL GENERATION AND DISTRIBUTION BORROWER INVESTMENTS, at ii (2000) (Audit Report No. 09601-1-Te).

[61] *See* TADLOCK COWAN, CONG. RESEARCH SERV., AN OVERVIEW OF USDA RURAL DEVELOPMENT PROGRAMS 18–19 (2007) (discussing the three basic loan types: hardship, municipal, and Treasury). *See also* U.S. GEN. ACCOUNTING OFFICE, RURAL UTILITIES SERVICE: OPPORTUNITIES TO BETTER TARGET ASSISTANCE TO RURAL AREAS AND AVOID UNNECESSARY FINANCIAL RISK 6–9 (2004).

billion to G&Ts.[62] Defaults on these loans have been rare,[63] partly due to easy credit from RUS, but have still cost several billion dollars. Though NRECA estimates that RUS programs cost only $25 million annually, the federal government's contingent liability is large.[64]

The few teeth in RUS regulations are found in RUS loan covenants and its annual surveys of co-op financials, which restrain co-op spending and standardize co-op reporting.[65] Almost half of co-op financing today, however, comes from a private, not-for-profit, co-op-owned lender, the National Rural Utilities Co-operative Finance Corporation ("CFC").[66] Thus, CFC borrowers do not have to publicly disclose their financials, thereby reducing oversight of the industry.[67]

CFC has been more than a lender to co-ops. It offers management and technical assistance and has been a financial innovator by offering "the forerunner for . . . mortgage-backed securities."[68] CFC also enabled co-ops to target different messages to different audiences without seeming to be inconsistent or hypocritical.[69]

---

[62] *See* Rural Utilities Service, USDA, Informational Pub. No. 201-01, 2005 Statistical Report: Rural Electric Borrowers 7 (2006) [hereinafter Co-op Statistical Report].

[63] *Id.* at 1 (noting that 9 borrowers have had loans foreclosed or settled by other means). The trend in foreclosures is very negative, however. From 1935 until 1980, only two co-ops required foreclosure, costing REA $37, 237. But in 1985, REA lost $486 million on the bankruptcy of a single G&T, Wabash Valley Power Association (Indiana). Other famous co-op problems of the period included Sunflower Electric Cooperative (Kansas), Deseret Cooperative (Utah), Soyland Power Cooperative (Illinois), Colorado-Ute Cooperative (Colorado), Illinois Valley Electric Cooperative (Illinois). See Williams, *supra* note 14, at 189, 215–40. From 1999 to 2003, RUS lost $3.2 billion on loans to just three borrowers. *See* Gen. Accounting Office, *supra* note 61, at 8.

[64] *See Examining the USDA's Rural Development Programs*, *supra* note 59, at 3 (statement of Glenn English, CEO, NRECA) ("It is important to note that the RUS electric loan programs will cost federal taxpayers less than $25 million to help capitalize a rural electrical infrastructure that is the envy of the world.") *But see* U.S Gen. Accounting Office, *supra* note 61, at 18–19 (noting that taxpayers faced a theoretical risk of loss of $3 billion in 2003, but that "in the event of default, likely maximum losses could be as much as $1.5 billion.").

[65] *See supra* note 55.

[66] *See Examining the USDA's Rural Development Programs*, *supra* note 59, at 3 (statement of Glenn English, CEO, NRECA). CFC could not have survived without a credential that is rare for a financial institution, a tax exemption from the IRS as a 501(c)(4) social welfare organization. *See* Williams, *supra* note 14, at 65. Also by 1984, the REA required all borrowers to have supplemental financings, such as from CFC. *Id.* at 159

[67] Co-ops' "financial and statistical operating reports are not generally matters of public record. If more details are needed, requests should be submitted directly to individual [RUS] borrowers." *See* Co-op Statistical Report, *supra* note 62, at 1. Of the 930 electric co-ops that belong to NRECA, only 607 were RUS borrowers in 2005, down from 612 in 2004. *Id.* at 9.

[68] Williams, *supra* note 14, at viii, 97.

[69] Id. at 269 ("NRECA might highlight the weaknesses in the program to gain support for continuing subsidized interest rates on REA loans, whereas CFC would highlight the strengths in marketing rural electric credit on Wall Street . . . We did not have a conflict in principle in supporting cooperatives, but sometimes we did have a conflict in approach.").

Co-ops continue to be largely free from regulation[70] due to political reluctance to interfere with what appear from the outside to be smoothly-running operations. Co-op members do not complain much, and politicians are afraid of angering co-op managers, directors and employees.[71] Co-ops are so influential inside their communities and keep such a low-profile outside that they are rarely in the news, except for occasional scandals.[72] Customer ownership is another reason for lack of scrutiny. In theory, electric co-ops are continually self-regulating,[73] just as agricultural co-operatives are.[74]

II. History of Electric Co-ops

Electric co-ops were created as one of President Franklin Roosevelt's New Deal programs in order to promote rural development.[75] When Roosevelt was elected in 1932, people living in cities had been enjoying the benefits of electricity for many years. Urban power companies were slow to reach out into the countryside, however, because of the high cost of wiring farms.[76] Frantic federal officials invented a new type of utility in 1935 to fill

---

[70] *See supra* notes 50, 51, 53. *Cf.* Stephen J. Piecara & Janet Marchibroda, *Primer on Rural Electric Cooperatives*, Cooperative Acct., 13–16 (1994) (claiming that co-ops "operate in a highly regulated environment," but admitting that only seventeen states regulate co-op rates).

[71] *See, e.g.*, Williams, *supra* note 14, at 259 ("Our political strength will maintain REA for some of us, I am sure, for the foreseeable future.").

[72] *See supra* notes 41-48. *See also* Editorial, *Utility Didn't Want 'No' for an Answer*, St. Petersburg Times and Hernando Times, Nov. 20, 2007, at Hernando Section 2 ("Florida has endured its share of ridicule because of its voting system. But the election methods being used by the Withlacoochee River Electric Co-operative make the state's system look like it is state-of-the-art."). *See also* Williams, *supra* note 14, at 232 (Illinois Valley Electric Cooperative had "substandard quality of service and irate membership" with rates 80% higher than neighboring utilities).

[73] *See, e.g.,* Colton, *supra* note 51, at 20 ("There is no need for protecting the members of the co-operatives from themselves." (citing Virginia Merrills, *Rural Electrification Cooperatives*, 20 Tenn. L. Rev. 406, 406-407 (1948); Hamilton Treadway, *The Public Utility Status of Rural Electric Co-operatives in Illinois*, 40 Ill. L. Rev. 515, 526 (1946)); Electric Bill of Rights, *supra* note 24, ("As recognized by federal courts, since the consumer owns the co-operative, there is no motive for the co-operative to mislead, cheat, overcharge, or act in any way that is not in the consumer-owners' interests."). *See also* Morrison, *supra* note 49.

[74] *See* Katherine L. Hanson, USDA Co-operative Information Report No. 55, Co-operatives in Agribusiness 2 (2000).

[75] *See* Amity Shlaes, The Forgotten Man: A New History of the Great Depression 175 (2007) ("Roosevelt decided now that . . . the government would . . . begin to control power in new areas. He had four goals. The first was to provide electricity to homes and farms–many farms were still without. The second was to increase the use of electricity in all homes, providing Americans with a better standard of living. The third was to reduce the cost of electricity to the average consumer. And there was a fourth, more ephemeral goal: that through the electricity industry the New Deal might create a new and more prosperous form of society.").

[76] *See* Heflebower, *supra* note 7, at 132 ("[C]ompanies usually required that farmers, individually or along a road, pay as much as $2,000 per mile to cover the cost of additional distribution lines, an unusual practice now. Prior to 1940, few farmers could make such outlays and also pay for wiring homes and for appliances.").

the need.[77] Part government agency,[78] part agricultural co-operative,[79] and part not-for-profit company,[80] this curious hybrid was named for the most innocent-sounding of its three components: co-operative.[81]

The word co-operative has deep resonance for rural residents due to the perceived fairness of its organizational structure and its widespread use in agriculture.[82] The co-operative principles of "user-ownership, user-benefit, user-control, and limited returns to the co-op"[83] seem neighborly and safe. It is often assumed that electric co-ops follow all of these co-operative principles since they share the name.[84] The failure of the federal government to precisely define "co-operative" has added to the confusion.

Unfortunately, electric co-ops are not genuine co-operatives[85] because they are not voluntary associations of people with specific expertise in the co-operative venture.[86] Although co-op membership may have been voluntary during the Depression when electricity was an exciting novelty, today it is a daily necessity. Customers do not freely choose to join an electric co-op;

---

[77] After private power companies failed to offer an adequate plan to electrify rural America, REA was flooded with loan applications from farm organizations. "REA staff was divided over the inexperienced co-ops' applications—most strongly against, but a few strongly for them. Cooke himself [the REA Administrator] was ambivalent . . . . By December, 1935, it was apparent that farm co-ops were going to the front as the primary borrowers under the REA program." THE NEXT GREATEST THING: 50 YEARS OF RURAL ELECTRIFICATION IN AMERICA 65 (Richard A. Pence ed., 1984).

[78] *See* WILLIAMS, *supra* note 14, at 5 ("When President Roosevelt established the REA, it was part of his overall program for unemployment relief."). The federal government allowed co-ops to borrow up to 100 percent of the cost of building distribution lines. When electricity could not be purchased at low enough prices, loans for generation capacity were provided as well. *See* HEFLEBOWER, *supra* note 7, at 132.

[79] Federal law does not define "co-operative," allowing advocates to mix elements from different statutes, and from the common law, to fit different situations. *See* JOHN A.C. HETHERINGTON, MUTUAL AND CO-OPERATIVE ENTERPRISES: AN ANALYSIS OF CUSTOMER-OWNED FIRMS IN THE UNITED STATES 108 (1991).

[80] Co-ops are private, not-for-profit corporations incorporated under state law. *See* THE NATIONAL SOCIETY OF ACCOUNTANTS FOR CO-OPERATIVES, FINANCIAL REPORTING BY CO-OPERATIVES 32-11 (1999).

[81] The more socialist-sounding name of "people's utility district" never gained currency. HEFLEBOWER, *supra* note 7, at 132.

[82] In 2000, there were 3,346 farmer co-operatives in the United States, with 254,658 employees. *See* HANSON, *supra* note 74, at 2; *see also* JERRY VOORHIS, AMERICAN CO-OPERATIVES (1961).

[83] DONALD A. FREDERICK, USDA, CO-OPS 101—AN INTRODUCTION TO COOPERATIVES 5–6 (1997).

[84] *See, e.g.*, NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 17-18. ("Seven Principles Distinguish Co-ops from Other Electric Suppliers. 1. Voluntary and Open Membership; 2. Democratic Member Control; 3. Member Economic Participation; 4. Autonomy and Independence; 5. Education, Training, and Information; 6. Cooperation among Cooperatives; 7. Concern for Community.").

[85] The first co-operative was formed in Rochdale, England in 1844 on the basis of what came to be called the "Rochdale Principles." Using many similar principles, an estimated 48,000 co-operatives of all types in the United States are generating $120 billion in economic activity for 100 million members. HANSON, *supra* note 74, at 2.

[86] *See, e.g.*, THOMAS W. GRAY & CHARLES A. KRAENZLE, RURAL BUSINESS CO-OPERATIVE SERVICE, USDA, RESEARCH REPORT NO. 192, PROBLEMS AND ISSUES FACING FARMER CO-OPERATIVES 50 (2002).

they buy from the monopoly because they have no choice.[87] Their only alternative is to "go dark," or possibly "go off-grid" by generating their own electricity. Co-ops not only effectively coerce membership,[88] but few, if any, co-op customers are knowledgeable about the electricity business. Co-op customers have other jobs and will sign almost anything to get electricity. The unique nature of electric co-ops is reflected in the state statutes under which co-ops are incorporated, statutes that treat electric co-ops differently than agricultural or other co-ops.[89] The federal tax code also distinguishes them.[90] Unfortunately, most courts have failed to note these crucial differences between agricultural and electric co-ops, particularly the need for greater protection of electric co-op members.[91]

Despite their identity problems, electric co-ops were the business prodigies of their time. The first electric co-op was born in 1934 in the back of a furniture store in Corinth, Mississippi.[92] Within a few years, it had a thousand siblings scattered across the nation. As the accompanying chart shows, before they were twenty years old, electric co-ops had accomplished the impossible: wiring ninety percent of their service territories. No private companies had ever stretched copper wire faster, over longer distances, or been a conduit of more federal subsidy dollars.[93] Electric co-ops eventually reached virtually all potential customers. Some co-ops are still struggling to make

---

[87] Hanson, *supra* note 74, at 46 ("Because electric and telephone co-operatives have exclusive rights to serve specified rural areas in most states, anyone living in those areas must join the co-operatives. That exclusivity of service is unique to utility co-operatives.").

[88] Although the first of NRECA's seven co-op principles is "voluntary association," it is essentially defined as non-discrimination by co-ops against paying customers: "Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination." http://www.nreca.org/AboutUs/Co-op101.htm (last visited Mar. 22, 2008). NRECA conveniently ignores the fact that co-op customers have no choice of electricity distributor.

[89] For example, most agricultural co-op statutes limit membership to farmers. James R. Baarda, Agricultural Co-operative Service, USDA, Informational Report No. 30, State Incorporation Statutes for Farmer Co-operatives 65 (1987) (surveying states' agricultural co-op statutes). *See also* NRECA & CFC, Task Force Report, *supra* note 17, at 59–60 (surveying states' electric co-op statutes).

[90] *See* NRECA & CFC, Task Force Report, *supra* note 17, at 54–58; Touche & Ross, Co., Accounting and Taxation for Co-operatives 323 (4th ed. 1978). *See also* Lee F. Schrader and Ray A. Goldberg, Farmers' Co-operatives and Federal Income Taxes (1975) (discussing non-electric co-operative taxation).

[91] *See, e.g.,* Peninsula Light Co. v. U.S., 552 F.2d 878 (9th Cir. 1977) (holding that an electric co-operative which charged members rates above costs in order to increase operating reserves was not required to distribute any of its surplus in order to preserve its tax-exempt status). *Cf.* French v. Appalachian Elec. Coop., 580 S.W.2d 565, 570 (Tenn. Ct. App. 1978) ("The membership may bring an appropriate action against the defendant if at some time in the future the defendant fails to properly distribute its revenues.").

[92] Lilienthal, *supra* note 39, at 20.

[93] *See* Williams, *supra* note 14, at 41 ("[Co-ops] were usually the largest business located in their service area.") *See supra* note 76 (noting the New Deal practice of private power companies charging large deposits before extending service, only to be circumvented by co-ops receiving large federal loans).

money in rural areas that remain poor, but some are now serving the richest urbanized counties in America.[94]

Co-ops were wildly popular in their youth. Ending the drudgery of washing clothes by hand, cooking with coal or wood, or reading by kerosene lamps was considered miraculous, especially since the private sector had failed at the job. Early co-op members felt reverence for the co-op's achievements. The official history of electric co-ops is entitled "The Next Greatest Thing," the first being God himself.[95] Co-ops were not satisfied with being competitive: unrivalled service was the goal.[96] This missionary zeal is preserved in the co-op statutes that still require co-ops to fund "education in cooperation" ahead of any member benefits.[97] Taken literally, this requirement means that $31 billion is available to educate Americans about this alternative to capitalism.

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

> I have been at such meetings where throughout a whole day as many as 2000 farmers and their wives and children discussed the financial and operating reports made to them by their superintendent and board of trustees [of the co-op], and later while we ate a barbecue lunch watched new uses of electricity demonstrated . . . . But these membership "town meetings" are not simply business sessions. They have an emotional overtone, a spiritual meaning to people who were so long denied the benefits of modern energy and convenience which had become a commonplace to their city neighbors. The talk turns to the hard days before "we won our fight," to the dark difficulties that had to be gone through before the crews came down the road, the poles were set, the copper lines were strung, and the lights went on.[98]

[94] 29.2% of co-ops now serve metropolitan areas (including the 9.4% of co-ops serving counties with over one million residents), 46.4% serve counties with more than 2,500 urban residents, and 24.4% serve counties with fewer than 2,500 urban residents. U.S. GEN. ACCOUNTING OFFICE, *supra* note 61.

[95] THE NEXT GREATEST THING, *supra* note 77, at 2. Another miraculous feature of co-ops was their frequent use of the honor system for billing. "[I]n order to keep expenses down, the members of the cooperatives read their own meters. The [commercial] bankers could not believe that." WILLIAMS, *supra* note 14, at 101.

[96] Today, the NRECA's "Electric Consumer Bill of Rights" concludes by saying "cooperatives should be able to work together to provide a 'yardstick' by which all consumers can measure the performance of the market and market participants." Electric Bill of Rights, *supra* note 24.

[97] *See* NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 59. ("Revenues of a cooperative for any fiscal year in excess of the amount thereof necessary . . . . To provide a fund for education in co-operation and for the dissemination of information concerning the effective use of electrical energy and other services made available by the co-operative, shall . . . be distributed by the co-operative to its members as patronage refunds . . . .").

[98] LILIENTHAL, *supra* note 39, at 19–20.

FIGURE 2: ANNUAL MEETING OF VERMONT CO-OP IN 1949[99]

As the decades passed, attendance at annual meetings fell because members started taking electricity for granted, even wasting power that had once been considered precious.[100] No one wanted to discuss co-op financial statements anymore. Co-op managers were busy maintaining existing power lines instead of building new ones.[101] They boosted sales by increasing customer density and by promoting appliances. They focused on higher co-op revenues, not lower member bills. Even the legal mandate for co-operative education dwindled into an automatic subscription to a co-op magazine with massive circulation, but barely a mention of co-op mechanics.[102] Today, co-

---

[99] Annual Meeting of Vermont Co-op in 1949 (National Archives Oct. 4, 1949) (on file with author).

[100] *See* James M. Andrew, Administrator, RUS, Remarks at NRECA Regional Meeting 25–26 (Sept. 26, 2007) ("The estimate is that between five and ten percent of our annual power bills is consumed by this so called phantom or vampire power. Another estimate is that seventy-five percent of the electricity used to power home electronics is still consumed even when we think the devices are turned off.") (transcript on file with the author).

[101] These impressions were gained by the author's attendance at local, state, and national co-op meetings over many years, beginning with an NRECA Manager's Conference, Aug. 10–14, 1996, at Hilton Head, South Carolina.

[102] *See, e.g.*, TENNESSEE ELECTRIC COOPERATIVE ASSOCIATION, TENN. MAG., Nov. 2003, at 4 ("Published monthly to communicate electrical use and safety, economic development, educational and community interests of more than 770,000 Tennessee families and businesses who

op insiders gather regularly at state and national conventions but do little to educate anyone, even themselves, about co-ops.[103] The most informative NRECA website, www.cooperative.com, is password-protected so that no outsider can access it.[104] Even co-op insiders seem to be unfamiliar with the site.[105]

Today, fast-growing metropolitan areas like Atlanta, Orlando, Washington, D.C., Cincinnati, Fort Worth, Austin, Denver, and Nashville have expanded into co-op service territory, blurring the lines between urban and rural, although many co-ops keep the adjective rural in their name.[106] Regardless of how urbanized their territory has become,[107] all co-ops can still receive federal loans under a policy entitled, "once rural, always rural." If you were eligible for government assistance in 1936, you are still eligible today.[108]

Today every electric co-op is about seventy years-old.[109] As co-ops have aged, their equity has grown from zero in 1936 to $31 billion today.[110] Despite this success, co-op managers have been surprisingly reluctant to share the news, or the money, with their members. NRECA began noticing this

---

own, operate and control the tax-paying, business-managed, locally owned electrical distribution and service systems of the Tennessee Electric Co-operative Association . . . . Cost of subscription to members of participating electric co-operatives is $2.40 per year (20 cents per month) . . . ."). The "total paid circulation" of this magazine in Tennessee was 523,847 in 2003. *Id.* at 24. Likewise, even the CFC reduced its mandatory educational efforts from 1% of net margins to 0.25%, which CFC maintained was sufficient for "meaningful education program" of $1.5 million from 1980 through 1994. See Williams, *supra* note 14, at 161.

[103] *See* Claudia Grisales, *Pedernales Co-op Executives–and their Spouses–Go First Class: Credit Card Bills Document Spending Habits of Utility's Top Officials*, AUSTIN AM.-STATESMAN, Jan. 6, 2008. *See also* Andrew, *supra* note 101, at 8–9 ("We all went to board meetings and did an hour or so deciding on a Ford or Chevrolet. Then the manager would present the REA report and it involved borrowing a million dollars for the future work plan. We would spend about five minutes on the report . . . . Long debate on trucks, short discussion on borrowing millions to operate the co-op.").

[104] Co-operative.com, http://www.cooperative.com (last visited Mar. 10, 2008). The author's congressional office was denied permission by NRECA to access the website for research on this article, but access had already been obtained by other means.

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

[106] For a list of co-ops by state, see National Rural Electric Cooperative Association, Our Members, http://www.nreca.org/AboutUs/OurMembers.htm (last visited Mar. 18, 2008). The word "rural" is more than a naming preference; the tax-exempt status of co-ops can depend on service to rural areas. See *infra* note 178.

[107] Average co-op customer density has more than doubled from 3.3 customers per mile in 1961 to 7 per mile today. *See* WILLIAMS, *supra* note 14, at 10. Today, 29.2% of co-ops serve metropolitan areas (including the 9.4% of co-ops serving counties with over one million residents). U.S. GEN. ACCOUNTING OFFICE, *supra* note 61, at 11.

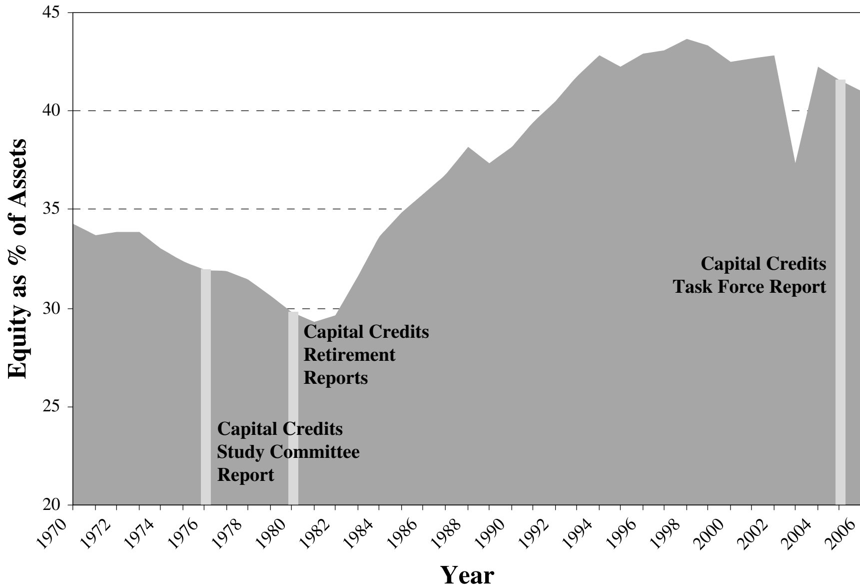
[108] *See* Tyrus H. Thompson, Editorial, *Once Rural, Always Rural*, NRECA LEGAL REPORTING SERVICE, Sept. 2004, at 3 (although the issue "has been brought to the attention of Congress many times . . . [Congress has] not enacted provisions or provided guidance for addressing or altering the Once Rural, Always Rural principle"). Federal policy is showing signs of change, however, with the Bush Administration's proposal for co-ops to recertify their rural status. *See infra* note 256.

[109] No tax-exempt rural electric co-ops existed before the New Deal, and the vast majority of co-ops were started soon after passage of the Rural Electrification Act of 1936 in order to take advantage of federal assistance in electrifying rural America.

[110] Co-ops by the Numbers, *supra* note 1.

unexpected but fundamental problem in the mid-1970s, urging co-ops to return equity to their customers more quickly.[111] Unfortunately, co-ops did the opposite, boosting equity levels to new highs as shown in the accompanying NRECA graph. After further warnings published in 1996, the NRECA commissioned another, more urgent report on capital credits in 2005, urging prompter and larger returns of equity.[112]

FIGURE 3: DISTRIBUTION SYSTEM EQUITY (PERCENT OF ASSETS)[113]



The reason for NRECA insistence on greater return of "capital credits" is that the tax and legal status of co-ops depends on such a policy. Under current law, failure to enforce an adequate capital credit policy is one way to lose tax-exempt status, and possibly even co-operative status.[114] NRECA still

[111] Calling this a "critical issue", CFC noted at the time that co-ops "didn't have a significant pattern of actually revolving capital credits . . . . Many systems were not even doing an effective job of keeping records, so that if they wanted to revolve capital credits they would have difficulty in doing so." WILLIAMS, *supra* note 14, at 105, 130. "[I]n 1975, only 127 co-ops out of 1,050" refunded capital credits despite high levels of equity, causing NRECA and the CFC to form the first Capital Credits Study Committee, which issued its "Final Report and Recommendations" in February, 1976. NRECA AND CFC, CAPITAL CREDITS STUDY COMMITTEE (1976); *see also* NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 13. Apparently, many co-ops did not get the hint, so the NRECA created a more focused Capital Credits Retirement Procedures Task Force, which issued its specific recommendations in 1980. *Id.*

[112] NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 30. *See also* NRECA & CFC LEGAL SUPPLEMENT, *supra* note 23, at 30.

[113] This graph was created by author's Legislative Director, James Leuschen. It is based on data provided by USDA's Rural Utilities Service (RUS).

[114] *See Id.* at 54–58.

considers co-op resistance to be a problem despite the fact that eighty-four percent of eligible[115] co-ops are returning some capital credits annually.[116] The reason for NRECA concern is the fact that co-ops are accumulating equity faster than they are refunding it.[117] Equity increased by $2 billion in 2006 alone, but only $499 million was refunded.[118]

It is noteworthy that NRECA could have a multi-decade disagreement with its members on such a fundamental issue. Clearly it is touchy; the major NRECA reports on capital credits are worded diplomatically and found only on their password-protected website, not in the public domain. NRECA knows that co-op managers simply do not want to relinquish control of their members' funds. Some managers fear that members might not understand that co-op equity is illiquid and that refunds are very limited.[119] However, co-op managers effectively control member opinion. There is little to prompt an inquiry or a complaint into these matters. Usually, members are grateful for any refund they receive,[120] having no way to compare it to the size of their investment in the co-op or to what other co-ops are paying. In areas with co-ops that refuse to refund, there are no membership certificates to remind members of their ownership because most co-ops were formed so quickly and with little expectation of profit.[121] Today, if certificates are offered at all, they are sold as souvenirs,[122] not as tangible proof of an account that is growing in value.

---

[115] *Id.* at 13 n.1.

[116] *Id.; see also, e.g.*, Nancy Kimball, *Flathead Electric to Rebate Three Million Dollars to Customers*, MONT. DAILY INTER LAKE, Oct. 30, 2007, http://www.dailyinterlake.com/articles/2007/10/30/news/news02.txt; *SCI REMC Members to Get $750,000 in Capital Credits This Holiday*, HOOSIER TIMES, Dec. 15, 2007, http://reporter-times.com/?module=displaysotry&story_id=9240&format=print; The Bus. J., *Energy United Awarding Members Capital Credits*, AMER. CITY BUS. JOURNALS, Dec. 17, 2007.

[117] Average member co-op equity has increased by $1 billion, or approximately $200 per member, just during the process of editing this essay. NRECA advocates using "Boatman's Theorem" to help co-op managers calculate and pay larger refunds. The Boatman Theorem indicates that the "percentage amount of equity that should be returned each year is equal to the difference between the co-op's rate of return on equity . . . and the co-op's growth in capital." NRECA & CRC, TASK FORCE REPORT, *supra* note 17, at 37.

[118] NRECA, PowerPoint Presentation: Vital Signs–How Rural Electric Systems Performed in 2006, at 43, 49 (Oct. 2007) ("Net Margins and Patronage Capital" increased to $112 per co-op customer in 2006)(on file with author).

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

[120] According to a survey commissioned by NRECA, 70% to 80% of co-op members think it is "very important" for "[c]o-operatives [to] give money back to their customers when revenues exceed costs." A majority of members over 55 think that such refunds are, in fact, made. However, younger members are more skeptical, with only one-third of 19 to 43 year-olds agreeing that co-ops ever actually refund capital credits. NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 66.

[121] The excitement and urgency of electrifying rural America, as well as the large federal subsidies required, caused people to underestimate the long-term development potential of the heartland. Some areas took longer to grow than others. As recently as the early 1950s, about twenty percent of electric co-ops were operating at a loss. *See* HEFLEBOWER, *supra* note 7, at 133.

[122] For example, a question in the "About Us" page of the Middle Tennessee Electric Membership Co-operative website asked, "Do the members actually own the co-operative?"

Even accountants,[123] lawyers,[124] and business people[125] are often unfamiliar with the unusual rules that apply to co-ops. Take, for example, the co-op practice of "special retirements." This common bylaw[126] allowed spouses of deceased co-op customers to obtain a refund of all or part of their capital credits, often to pay for burial expenses. Sadly, co-op practices like this are not always honored despite substantial national payouts.[127] Member-friendly co-op managers should never fail to mention the "special retirement" opportunity to the widow or widower.[128]

The genius of co-ops is their hybrid nature, which has allowed them to adapt to gradually changing conditions. As the following chart shows, most co-ops have experienced three phases, each one featuring a different hybrid element.[129] Co-ops acted much like "government agencies" from 1936 to 1973 because they received so many federal tax dollars. Co-ops resembled true "co-operatives" from 1974 to 1984 because they were able to generate sufficient member equity. Finally, co-ops grew more ambitious and began acting like not-for-profit or even for-profit businesses from 1985 to the present.[130] Of course, each co-op has matured at its own rate, depending on its

The co-op's answer was: "Yes. Members pay $5 for a membership certificate, which grants the rights and privileges of ownership." Middle Tennessee Electric Membership Corporation, What's a co-op?, http://www.mtemc.com/faq.cfm/name/1#faq6 (visited Mar. 2, 2004). The co-op's answer has subsequently been changed to "Yes. The members are the co-operative." *Id.* (last visited Mar. 10, 2008).

[123] Co-op accountants have their own association, the National Society of Accountants for Co-operatives, and journal, The Co-operative Accountant. The autobiography of a certified public accountant who claimed to have audited more electric co-operatives than anyone else reveals many of the quirks of the business. *See* Walter G. Schmidt, Rural and Supply Co-operatives Were My Concern 176 (1987).

[124] Co-op lawyers are encouraged to belong to the Electric Co-operative Bar Association in order to keep up with co-op law. NRECA, Sample Electric Co-operative Attorney Policy, 8 (2003) (on file with author). Co-op legal documents are relatively obscure and are often only found on NRECA's password-protected website.

[125] Although classes on non-profits are increasingly available, very few business schools offer courses on co-operatives, a term that is often used to mean either a type of apartment in cities like New York, or a student internship at the business of a prospective employer.

[126] *See, e.g.*, Middle Tennessee Electric Membership Corporation, Bylaws art. I, § 9(a) (2006), *available at* http://www.memtc.com/acrobat/BylawsElectranet_20061207.pdf ("when in the judgment of the Board of Directors, the financial condition of the Co-operative justifies it, the Board may authorize the repurchase of the membership of any deceased member, such membership to be held by the Co-operative as a treasury membership which may be disposed of by the Board of Directors upon non-discriminatory terms.").

[127] NRECA & CFC, Task Force Report, *supra* note 17, at 59 (in 2003, $94 million of special retirements were made, versus $351 million in general credit retirements.)

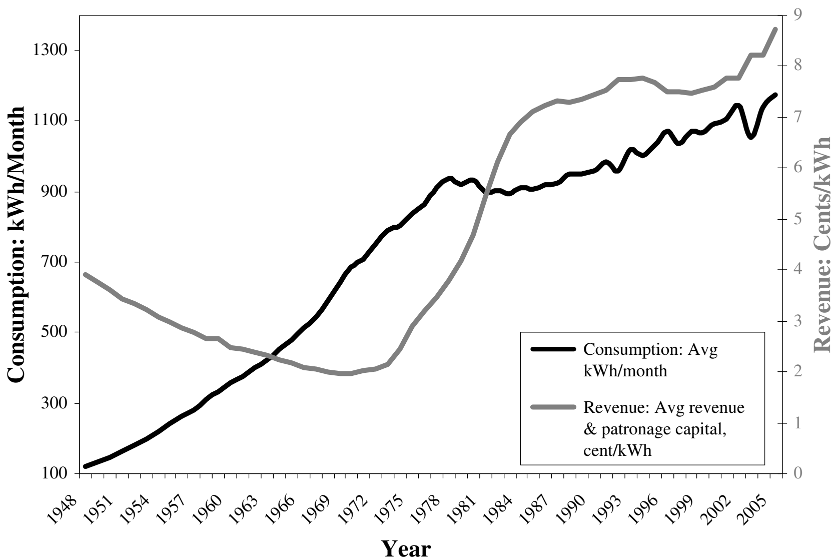
[128] NRECA urges its co-ops to pay attention to the age of its members in order to better anticipate their attitudes and needs. *See id.* at 65, also note 118.

[129] *Cf.* Scott Ridley, Profile of Power, American Public Power Association (1996) (Ridley divides the public power industry into five phases: infancy from 1879–1907, private-sector consolidation from 1907–32, creation of rural co-ops and federal power projects from 1933–61, completion of the grid from 1961–89, and the new era of deregulation and competition 1990–96).

[130] Changes in government loan policy did much to shape behavior. Until 1973, the REA offered direct 2% loans to co-ops, then shifted to 5% loans and loan guarantees in an effort to reduce federal government subsidies to co-ops. Williams, *supra* note 14, at 113–14. *See also* Public Utilities Reports, *supra* note 13, at 18–24. The next big shift in government lending

local service area, so it is difficult to generalize. Some small co-ops are still in their "government agency" stage,[131] and may remain so. Some still act like genuine co-operatives.[132] But others grew so rapidly that they quickly became, like the Atlanta co-op that subcontracted out its entire operation,[133] distressingly similar to for-profit enterprises. Many co-op observers, including many co-op directors, have not understood the gradual transformation of co-ops from emergency relief agencies[134] to, in some cases, wealthy power companies.[135]

FIGURE 4: RESIDENTIAL ENERGY CONSUMPTION & REVENUE/KWH[136]



policy was in 1993, when the Clinton administration moved to market-rate loans, reserving 5% loans for only the neediest borrowers. As the federal government receded from utility lending market, CFC and CoBank (a bank created for rural cooperatives) filled the void. WILLIAMS, *supra* note 14, at 266–67.

[131] *See, e.g.*, CO-OP STATISTICAL REPORT, *supra* note 62, at 76 (Swans Island Electric Cooperative of Swans Island, Maine, serves only 575 customers, and has only 7% equity as a percentage of assets).

[132] *See, e.g.*, *id.* at 42 (discussing La Plata Electric Association in Durango, Colorado, with 36,772 customers and an equity to assets ratio of 38%).

[133] *See* Newkirk, *supra* note 42.

[134] Co-ops, and even co-op banks, have stressed almost from the beginning that they are not utilities but "social welfare agencies." WILLIAMS, *supra* note 14, at 65. Co-op performance was supposed to be superior to anything that for-profits could produce. *See supra* note 96.

[135] *See* WILLIAMS, *supra* note 14, at 48–49 ("[T]he same people were sitting on the boards who were sitting on the boards when the co-op was founded. These were well-meaning, dedicated individuals, but the co-op they were involved with in the early days was no longer the same organization thirty years later. It was a more complicated, more sophisticated operation, and a lot of directors didn't keep up to date. There was a crying need for turnover.").

[136] This graph was created by author's Legislative Director, James Leuschen. It is based on data from PUBLIC UTILITIES REPORTS, *supra* note 13, at 22.

Not only does excessive equity endanger co-op tax and legal status, it also makes electric co-ops attractive takeover targets despite numerous barriers (particularly against IOUs) to acquisition.[137] A more subtle danger to co-ops is their attractiveness as a financing source for the estimated $35 billion in new electricity generating capacity that may be needed in America over the next thirty years.[138] Co-ops are being targeted due to their apparently deep pockets, low cost of capital due to their tax-favored status, and (except for a few G&Ts) relative inexperience in power generation.[139] Co-ops are probably not the most astute investors in new generation facilities.

NRECA is asking co-ops nationwide to conduct "Straight Talk" campaigns in their communities to spread the message that "rates are going up" because of new generation and pollution controls.[140] This message creates an expectation of increased co-op revenues and blames government for new regulations. But such "Straight Talk" efforts are also an opportunity for co-ops to level with their members on all issues, including ways of reducing members' bills with improved efficiency, capital credit retirement, conservation, and avoiding unnecessary plant construction and pollution-control costs.

III. Member Control of Electric Co-ops

A. *Equity Interest*

Electric co-op customers own their co-op. The more electricity a member buys from the co-op, the more equity he or she owns.[141] The average monthly electric bill in 2006 was $102 for a co-op residential customer.[142] These bills are not itemized; customers cannot see the wholesale cost of electricity, cost of retail distribution, overhead and interest expense, or the co-op equivalent of profit—the average seven percent additional "margin".[143] In good years, the co-op accumulates this operating income mar-

---

[137] *See* NRECA & CFC, Task Force Report, *supra* note 17, at 11 ("Sellout exposure: Could failure to retire capital credits lead to internal or external pressure to sell the co-operative?"). Most state co-op statutes have a variety of anti-takeover protections, particularly against IOUs, such as a requirement that other co-ops be given a first right-of-refusal before any acquisition could take place. These protections limit the "market for corporate control" described in Henry G. Manne, *Market for Corporate Control*, 73 J. of Pol. Econ. 110 (1965).

[138] *See* NRECA, 2006 NRECA Annual Report 3 (2006), *available at* http://www.nreca.org/Documents/AboutUs/NRECA_AnnReport.pdf [hereinafter NRECA Annual Report]. Note in particular the letter from the CEO promoting 15,000 megawatts of new power generation for co-ops. *Id.* at 1.

[139] *See Distributors Want to Help Fund TVA Plans for New Power Stations: Group Would Have Ownership Stake in Venture*, The (Nashville) Tennessean, Jan. 7, 2008, at B2.

[140] English, *supra* note 24, at 12.

[141] See Public Utilities Reports, *supra* note 13, at 83.

[142] NRECA Strategic Analysis (Apr. 27, 2007), http://www.cooperative.com (password protected).

[143] Framework, *supra* note 27, at 34.

gin[144] much like retained earnings. The accumulated margin is called "capital credits," "patronage capital," "member equity," or "total earnings reinvested in the system," depending on each co-op's preferred terminology.[145] Today almost every co-op has millions of dollars, if not tens or even hundreds of millions of dollars of capital credits,[146] which, when allocated to members according to their usage, determine the members' exact legal ownership of the co-op.[147] When this equity is finally transferred to members, it may be called "capital credits," "refunds,"[148] "return of capital," or "dividends."[149] In short, for about seven dollars a month, co-op members own a growing share of an electric utility, whether they want to or not.

The converse of the customer/owner principle is that non-members may not own any of it.[150] This restricts the co-op's source of capital to insiders. Co-ops' deep suspicion of outside capital[151] extends even to their own wealthy members, who are not allowed to buy more equity in the co-op than their usage would dictate. Co-ops overcame their initial lack of equity with long-term loans from the Rural Electrification Administration, the predecessor to the RUS, for up to 100% of the cost of line construction or power generation.[152] As start-up enterprises in poor rural areas, co-ops could not have survived without receiving and distributing federal funds as quasi-governmental agencies.

The average co-op member owns roughly $1824 of equity in his or her co-op,[153] but accounts can range from hundreds of thousands of dollars for heavy commercial users to almost nothing for new customers. Although

---

[144] Non-operating income, such as investment income or money management income, may not accrue to a member's benefit. NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 25.

[145] The Middle Tennessee Electric Membership Co-operative uses the term "total earnings reinvested in the system." *See, e.g.*, *TVA Rate Adjustment Means Higher Bills for MTEMC*, *supra* note 102, at 3, 14.

[146] In 2005, only 15% of co-ops failed to report positive margins, and the average co-op equity level was 42%. See CO-OP STATISTICAL REPORT, *supra* note 62, at 19.

[147] There appears to have been a long-lasting disagreement between NRECA and the IRS about the need to promptly allocate margins to customers. *See* SCHMIDT, *supra* note 123, at 175. ("My advice to our clients was to assign all margins to patrons and to notify the patrons as required by the IRS."). NRECA comes down strongly on the side of annual allocation. *See* NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 24. Allocation does not mean rights to capital credits have vested; vesting occurs only when the credits are retired. *Id.* at 33.

[148] *See* R. Jeff Turnage & James H. Pollack, *Utility Co-operative Forum: TAMs Bring Good/Bad New on Patronage Dividends*, CO-OPERATIVE ACCT., Summer 1996, at 1, 60–64 (1996) (describing a variety of terms for these payments).

[149] Members of rural electric co-operatives "share in operational profits, just like members of other co-operatives, through patronage dividends." HANSON, *supra* note 74, at 48.

[150] *See* PUBLIC UTILITIES REPORTS, *supra* note 13, at 7.

[151] Not only do co-ops fund themselves with member equity, even their debt comes from either the government, RUS, or a co-operatively-owned lender, CFC. Even a newer lender like CoBank is a subsidiary of a government-sponsored enterprise. See PUBLIC UTILITIES REPORTS, *supra* note 13, at 94–95.

[152] *See supra* note 78.

[153] This rough calculation divides total co-op equity ($31 billion) by total number of co-op customers (17 million). *See* Co-ops by the Numbers, *supra* note 1.

$1824 may seem *de minimis*, the average American family has only $3,105 in brokerage accounts and $3469 in checking and savings accounts.[154] Like stock, co-op equity conveys to the owner an interest in the residual assets of the co-op in the event of liquidation.[155] Unlike stock, it is often overlooked, not only by its owners but also by bankruptcy courts,[156] divorce courts, welfare administrators, and others with a claim on a member's assets.

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

- An investment: Since a member's margin payment becomes equity in the co-op, it resembles an investment. Indeed, that term is commonly used in co-op literature, although it differs from a normal investment because it does not pay explicit dividends or interest.[157] NRECA acknowledges that members rightfully expect significant benefits from their investment, if only due to its opportunity cost, but the investment's intangible benefits are hard to identify.[158] The argument that the margin payment is an investment has very serious consequences because member equity could then become a "security" under federal securities law.[159] The legal argument for terming the payment an "investment" hinges on an investor's initial expectation of return,[160] a test

[154] *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, Fed. Reserve Bull., 2006, at A1, http://www.federalreserve.gov/pubs/oss/oss2/2004/bull0206.pdf.

[155] *See* Peninsula Light Co. v. U.S., 552 F.2d 878, 879 (9th Cir. 1977) (In the event of "dissolution of the corporation, the articles provide that the net assets would be distributed equally to the members of the corporation.").

[156] *See* NRECA & CFC, Legal Supplement, *supra* note 23, at 39–49.

[157] The common understanding of the member/co-op financial relationship is as follows: "Patronage capital, capital credits, member equity—by any name, any co-op revenues in excess of expenses, or margins, are investments by members in the organization and ultimately belong to the members and should be returned to them . . . . A co-operative member does not receive a return on this investment in the co-operative, other than the ability to buy power essentially at cost." Public Utilities Reports, *supra* note 13, at 83.

[158] NRECA & CFC, Task Force Report, *supra* note 17, at 37 ("While each member is different, the cost of its equity investment in the co-op is probably at least as high as the return the member could expect to earn on a similar investment, such as a ten-year Treasury bond, and may be as high as a credit card rate."); USDA, *Co-operative Financing and Taxation* 11 (Rural Business Co-operative Service 1995) ("The member should still attempt to measure the return provided by the investment in the co-operative. One measure may be the lower price paid on products or services purchased . . . . A member must evaluate the transaction price, plus the value of patronage refunds and the discounted value of retains to be received in the future, to arrive at the total return on investment.").

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

[160] The so-called Howey test was reiterated in United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851–52 (1975) (citing SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946)). The

which makes little sense in the context of forced membership in electric co-ops.

- A loan: Since many co-ops return members' margins after twenty years, usually without interest, the property interest resembles a bad loan because, after inflation, members receive roughly half the value of their original margin payment.[161] Members usually do not complain about this return because they have low expectations. They are largely unaware that the growing prosperity of their co-op allows the return of more margin dollars, and without a twenty-year delay.
- A capital contribution: The argument for treating a member's interest as a capital contribution is that membership conveys intangible benefits,[162] similar to membership in a country club. According to the NRECA Electric Consumer Bill of Rights, "the co-op difference resides in customer ownership and control."[163] Perhaps because this control is so tenuous, the NRECA advocates return of capital credits because that shows "tangible evidence of members' ownership in the co-operative and demonstrates the difference between co-operatives and other organizations."[164]
- A donation: If you believe that margins are hopeless investments or loans, it is a short step to believe that they are charitable gifts contributed for the good of the co-op and the community.[165] Co-ops encourage this view with "Operation Roundup" and trips to Washington for co-op youth.[166] However, this causes confusion between the 501(c)(12) status of co-ops and the 501(c)(3) status of charities. Elec-

---

Howey test requires four elements to be present in any security: an investment of money, in a common enterprise, with an expectation of profits, to be derived solely from the efforts of others. *Id.* at 851-52. The most recent case, Great Rivers Co-operative of Southeastern Iowa v. Farmland Indus., Inc., 198 F.3d 685, 699–701 (8th Cir. 1999), noted:

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

[161] Forty-three percent of co-ops that refund capital credits use the first-in, first-out (FIFO) method to benefit the oldest members. This method gives priority to returning the earliest margin payments by customers, usually decades earlier. These co-ops often use a twenty-year rotation cycle, although length of the cycle can vary. *See* NRECA & CRC, TASK FORCE REPORT, *supra* note 17, at 41.

[162] PUBLIC UTILITIES REPORTS, *supra* note 13, at 83 ("A co-operative member does not receive a return on this investment in the co-operative, other than the ability to buy power essentially at cost.").

[163] Electric Bill of Rights, *supra* note 24.

[164] PUBLIC UTILITIES REPORTS, *supra* note 13, at 84.

[165] Business customers may make the same current expense deduction whether the electricity purchase is treated as an ordinary and necessary expense or a donation. *See* I.R.C. §§ 162, 170 (2006).

[166] Many co-ops boast of their charitable work funded by members who choose to "round up" their utility bills to the nearest whole dollar. This, of course, slightly increases members'

tric co-ops are not charities; they are not-for-profits that are free to pursue profit as a secondary objective.[167]

Regardless of how the co-op member's margin payment is classified, return on that payment is central to the operation of the co-op.[168] In fact, failure to return capital credits can destroy the tax-exempt status of the co-op by depriving customers of membership status.[169] Despite the critical nature of this requirement, it is hard to find a single co-op that can prove it has returned the right amount of capital credits, or, for that matter, kept member rates low or electric bills at a minimum. Co-ops do not want outsiders to check their results of operations;[170] they argue that co-op procedures automatically produce superior outcomes.[171]

What about co-op procedures? Co-op business software keeps exact accounts of each member's allocated ownership in dollars and cents, but these accounts and amounts are seldom, if ever, revealed to members, or allowed to vest until the actual refund occurs.[172] Since co-ops are in constant contact with members by means of monthly bills and issues of a co-op magazine, this failure to communicate important information is troublesome. Another concern is the simplistic, self-serving financial information that is released annually to co-op members in lieu of financial statements.[173] Members receive less factual information than the owners of any other widely-held company.[174] Comparisons with other co-ops' performance are never made. This paternalistic treatment makes it extremely difficult for anyone but a specialized researcher to understand a single co-op, much less the industry's performance as a whole. The only new window on co-op performance is the

---

bills, although it is done voluntarily. Many co-ops also invite selected high school students in the co-op's service area to travel to Washington, D.C., partially or wholly at co-op expense.

[167] NRECA & CFC, Task Force Report, *supra* note 17, at 54–58.

[168] *Id.* at 9 ("allocating and retiring capital credits are two of the practices that distinguish co-operatives from other businesses . . . . Adopting and implementing a capital credits policy are key responsibilities of a co-op's board of directors and management."); Thomas M. Strait, *Patronage Dividends of Electric and Telephone Co-operatives*, Co-operative Accountant, Summer 1995, at 58 ("a utility co-operative's patronage dividend ('capital credit') policies are crucial to its competitive position and financial integrity.").

[169] Bill Clayton & Russell D. Wasson, Introduction to Utility Co-operative Taxation (2005), *available at* http://www.cooperative.com (password protected).

[170] TVA began marking its annual "Summary of Financial Statements, Sales Statistics, and Rates: Distributors of TVA Power" as "Business Sensitive" on June 30, 2002, in order to limit disclosure of muni and co-op finances, despite their public power status and the availability of their not-for-profit 990 tax returns.

[171] After the Enron scandal, for example, NRECA officials stressed that such problems could not occur in member-owned co-ops. *See, e.g.*, Morrison, *supra* note 49.

[172] The exact sequence in which capital credits return to members—allocation, vesting, retirement, and distribution—is seldom revealed to members, and seems poorly understood by co-op managers themselves. *See* NRECA & CFC, Legal Supplement, *supra* note 23, at 12.

[173] Non-members lack access to any co-op financial information because co-ops are viewed as private companies, not publicly-owned utilities. *See* Public Utilities Reports *supra* note 13, at 8.

[174] *See, e.g.*, Morrison, *supra* note 49, at 1–10 (never mentions disclosure obligations of co-ops); *see also* John D. Reilly, *Recent Changes to the State Securities Law Exemption for Cooperatives,* Co-operative Accountant, Summer 1996, at 3.

availability of IRS Form 990, a disclosure required from any tax-exempt entity.[175]

A co-op must meet three different sets of conditions to maintain its tax-exempt status. The co-op must be a genuine co-operative, an electric co-operative, and a tax-exempt electric co-operative. Specifically, a genuine co-operative must subordinate its capital and ensure democratic control, allocation of capital, and operation at cost.[176] An electric co-op must serve "rural areas"[177] and generate at least eighty-five percent of its income from selling electricity to its members.[178] Finally, an exempt electric co-op must not withhold member access to co-op accounts[179] or retain earnings "beyond the reasonable needs of the organization's business."[180] NRECA seems worried that many co-ops may be violating one or more of these conditions.[181] There are three levels of penalties for failing these tests: become a taxable electric co-op, a taxable general co-operative, or, worse, a "membership organization" with less favorable tax treatment than a corporation.[182]

Two of the specific conditions the IRS requires of exempt electric co-ops—the ban on closed records and excessive reserves—are easy to understand, even if they are not easy to define. A third condition—that electric co-ops may not forfeit member assets—requires some additional explanation. A

---

[175] Co-op 990 tax returns may be accessed at http://www.guidestar.org or http://foundation center.org; *see also* Electric Co-operative Bar Ass'n, PowerPoint Presentation: About Hot Topics in Form 990 Compliance 50–52 (June 12, 2007).

[176] I.R.C. § 501(c)(12)(A) (2006); *see* Exempt Organizations; Proposed Examination Guidelines Regarding Rural Electric Co-operatives, Announcement 96-24 (1996).

[177] Rural area is defined as "any area of the United States not included within the boundaries of any urban area, as defined by the Bureau of the Census. . . ." Rural Electrification Act of 1936 tit. 1, § 13, 7 U.S.C. § 913 (2006). The Census defines an urban area as populations of "at least 2,500 for urban clusters, or at least 50,000 for urbanized areas." *See* http://ask.census.gov/cgi-bin/askcensus.cfg (copy on file with author). According to these definitions, only 24.4% of co-op counties can claim to be rural areas. See U.S. Gen. Accounting Office, supra note 61, at 12. This could mean that 75.6% of co-op counties are already ineligible for service by tax-exempt co-ops under the statute.

[178] I.R.C. § 501(c)(12)(A) (2006). Anything other than sales of electricity to members may be classified as "unrelated business income" and is limited to less than fifteen percent of co-op business. See Wasson, *supra* note 17, at 2.

[179] Co-op financial records, including a member's capital credits account, are supposed to be "open and accessible to members at any time." Rev. Rul. 72-36, 1972-1 C.B. 151.

[180] *Id.*

[181] The 1976, 1980, and 2005 NRECA Capital Credits Reports repeatedly admonished, in increasingly urgent language, that "[a] co-operative's policy for allocating and retiring capital credits must comply with applicable state and federal laws as well as the co-op's articles of incorporation and bylaws," NRECA & CRC, Task Force Report, *supra* note 17, at 12. The NRECA's Director of Tax, Accounting, and Finance Policy, warns "It is very important . . . for an electric cooperative to comply with the cooperative principles and remain a 'cooperative' under federal tax law." Wasson, *supra* note 17, at 5.

[182] Taxable electric co-ops are governed by pre-1962 co-op case law, taxable general co-ops are governed by I.R.C. Section 1381 (Sub T), and co-ops that lose all of their tax-favored status are corporations classified as "membership organizations." This may be roughly described as descending from tax-exempt status for the co-op and its members, to federal taxation at the co-op level, to federal taxation at both the co-op and member level. *See* Wasson, *supra* note 17, at 7.

member's capital account may not be terminated without consent of the member, the member's estate, or—in the event the estate's books are closed—his or her descendants.[183] The enduring nature of this obscure property right has surprising implications. State escheat laws and unclaimed property laws often do not apply to capital accounts, even for those that have been dormant for decades.[184] The good news for members is that children and grandchildren can often get full credit for the original co-op member's account. The bad news for co-ops is that refusal to refund capital credits or settle with estates means that co-ops are increasingly owned by former customers, whether they are deceased or living in another area. No one knows how many co-ops have fifteen per cent or more of their equity owned by non-members, such as dead or absent customers, but this could also force revocation of a co-op's tax-favored status.[185]

B. Voting Rights in Co-ops

In contrast to the complexity of co-op capital accounts, the voting rights of members are simple: one member, one vote.[186] Unlike with IOUs, even large "shareholders" only get one vote. This radically democratic policy not only reduces the influence of a large customer in co-op elections, but also reduces his or her interest in participating at all. Co-ops usually ban proxy voting on the New Deal theory that all members should attend annual meetings because nothing could be as urgent as the co-op's ability to electrify your home or farm.[187] At these annual meetings, quorum requirements are impractically high for fundamental changes in the co-op but comparatively low for director elections.[188] Without proxy voting, requiring a super-majority for mergers or acquisitions makes such transactions nearly impossible.[189]

---

[183] Rev. Rul. 72-36, 1972-1 C.B. 151; 26 C.F.R. 1.501(c)(12)-1 (2007).

[184] NRECA & CRC, LEGAL SUPPLEMENT, *supra* note 23, at 50–52.

[185] At least eighty-five percent of co-op income must come from member purchase of electricity. *See* Bill Clayton, Vice President e-Business and Marketing, Co-operative Fin. Corp., & Russell D. Wasson, Director of Tax, Fin., and Accounting, Nat'l Rural Elec. Co-operative Ass'n, Remarks at Accounting, Finance & Tax Conference: Introduction to Utility Co-operative Taxation, PowerPoint (May 16-19, 2005).

[186] *See* PUBLIC UTILITIES REPORTS, INC., *supra* note 13, at 7.

[187] *See* Roger Croteau, *Legislator Says Utility's Reforms Fall Short*, SAN ANTONIO EXPRESS-NEWS, Nov. 15, 2007, at 1B. Pedernales now allows proxy voting and for petitions from 25 or more members to nominate new members for the board, but still counts unmarked proxies as votes for the management slate.

[188] Compare the Tennessee legislature's quorum requirements: the lesser of 100 members or 2% of membership for transacting regular business at the annual meeting (which may fall to 51 people or 1% once a quorum is established) versus a meeting-long requirement of ten percent of membership in person for any substantial asset sale or other major co-op transaction. TENN. CODE ANN. §65-25-211(d) (2000).

[189] For example, the ten percent permanent quorum requirement for Tennessee co-ops would mean that, for the largest co-op, over 15,000 customers would have to gather and remain in attendance in order to consider a major co-op transaction. In the current Pedernales scandal, less than one-fifth of one percent of Pedernales membership participated in any way in one of the nine public forums designed to elicit customer views. *See* Claudia Grisales,

Conversely, the number of co-op employees may be enough to pick all the directors during an annual meeting that is poorly attended by members who are not employees.[190] Such rules serve to entrench co-op directors, management, and employees.

Co-ops are governed by a board of directors composed of members from each of the co-op's service areas, elected by the general membership. Co-op board seats are very attractive positions, but few members apply because they know little about the benefits, which appear to be nominal according to the bylaws. In reality, according to the new Form 990 disclosures, annual compensation for co-op board members can reach $15,000 to $50,000,[191] depending on the size of the co-op, frequency of meetings, value of health insurance, and attendance at expense-paid state and national conventions. No expertise is required. Co-op board members sometimes display astonishing ignorance of co-op business but are insulated from liability for their decisions due to the co-op's not-for-profit status.[192] Sarbanes-Oxley requirements for independent directors or audit committee experience do not apply.[193] The ability of co-op employees to control these board seats—and, through the directors, the co-op—has made employees much more influential than the co-op's apathetic membership.[194] Co-op managers and employees have often become the de facto owners of the co-op.

IV. Co-op Treatment of Members

There is no bright-line test to determine whether a co-op has surplus equity and therefore must lower rates, return member equity, or promote

Utility Customers Speak Up for a More Open Board, Austin Am.-Statesman, Oct. 21, 2007, at B1. Co-ops realize that supermajority requirements are unrealistic and have modified them in order to allow co-ops to borrow from CFC. See Williams *supra* note 14, at 67.

[190] *See supra* note 188; *see also infra* note 193. Co-ops usually hire employees from their service area, partly because others would have too far to drive and partly because it is very convenient for employee-members to be able to vote with management in co-op elections. From an employee standpoint, co-ops provide stable employment in areas that may provide few other jobs. *See supra* note 93.

[191] The chairman of the Pedernales board was paid almost $200,000 annually. *See* Roddy Stinson, *PEC Board's Pay, Perks Are Filed with IRS–And They're Astounding*, San Antonio Express-News, Nov. 25, 2007, at 1B.

[192] *See supra* note 135. "White-collar rural residents, who provided the greatest economic growth, were underrepresented on the systems' boards." Williams, *supra* note 14, at 214. For many years, almost two-thirds of co-op directors were farmers, although only 12% of co-op members were farmers. *Id.*

[193] *See* Claudia Grisales, *Pedernales Co-op Changes Leaders and Bylaws, but Members are Still Locked Out*, Austin Am.-Statesman, Jan. 6, 2008, at A1, *available at* http://www.statesman.com/business/content/business/stories/other/01/06/0106pecgovern.html.

[194] For example, in the Pedernales scandal, "co-op employees at the forums were attentive and at times outnumbered those in attendance." Claudia Grisales, *Pedernales Customers Give Co-op Their Ideas*, Austin Am.-Statesman, Sept. 29, 2007, at E8.

energy conservation. But there are frequently unexplored ways for the co-op to lower its operational expenses without harming service.[195]

A. Distribution (In)efficiency

The core business of co-ops is distribution ("wheeling") or delivering electricity to local meters for as few cents per kilowatt-hour as possible. Different regions have different wholesale costs of electricity (depending, for example, on the availability of hydro power) but all regions can try to distribute electricity efficiently. In 2005, the average co-op charged 2.56 cents per kilowatt-hour, or roughly one-third of its total rate, for distribution costs.[196] This is more than double the one-cent per kilowatt hour average distribution cost for IOUs, which serve higher density areas but which are also more efficient.

Co-ops prefer to focus customer attention on their all-inclusive rates, without breaking out the cost of distribution. This policy hides their relative inefficiency and gives them credit for others' low-cost generation.[197] Co-ops also resist focusing on the volume of electricity purchased—the kilowatt hours—although such information could help customers decide how to reduce wasteful purchases. Reducing either the price or volume of electricity threatens co-op management, however, since managers are motivated to improve the co-op's top-line revenue, not the member's bottom line.[198] An extremely successful conservation program would make the co-op look like it has stopped growing, and co-op managers lack incentives to promote such a result.

The relatively high cost of co-op distribution is due to dispersed customers, a high number of employees per customer, and excessive investment in capital plants. Scale is the primary factor. The 43 co-ops with fewer than

---

[195] A small but telling example of prolonged co-op inefficiency was the fact that from approximately 1930 to 1970, all co-ops mailed their interest payments on REA loans to Washington, D.C. Co-ops lost an average of 60 days of float annually on billions of dollars. Only CFC's "check delivery" service in 1975 began improving their money management. *See* WILLIAMS, *supra* note 14, at 133. As a result of this reform, non-operating margins nearly doubled from $33.2 million in 1976 to $62.6 million in 1979. *See id.* at 127.

[196] NRECA, U.S. ELECTRIC UTILITY OVERVIEW (2007) (indicating that the average distribution cost for all utilities is 2.1 cents per kilowatt-hour. Co-op costs are not released but can be derived from CO-OP STATISTICAL REPORT *supra* note 62, at 20. *See also* FRAMEWORK, *supra* note 27, at 30.

[197] Another way that co-ops get credit for others' generation is when co-ops use gross receipts instead of gross income as the denominator in their calculation of the fraction of unrelated business income. Gross receipts is defined as gross income, plus the cost of wholesale power. "[F]or most cooperatives, gross receipts is an easier test to pass than gross income." WASSON, *supra* note 17, at 2.

[198] *See* LILIENTHAL, *supra* note 39, at 22. (noting that as of 1944 "[o]f the eighty-four municipal distributors of TVA power that have been operating two years or more, all except three exceed the national average in the use of electricity in homes . . . . In the homes of forty-two of these cities and towns the average use is 50 per cent greater than the national average . . . . In thirteen communities the average use is 100 per cent greater . . . .").

2500 customers charge each member $531 for distribution every year, whereas the 144 co-ops with more than 25,000 customers have reduced the cost to $266 each.[199] According to the NRECA, mergers among the co-ops that are uneconomically small could save customers at least $220 each per year, resulting in huge savings for customers:[200] this amount is roughly the equivalent of two free months of electricity. Trimming payrolls and optimizing capital plant investments can also make distribution more efficient. The median customer-employee ratio is 276 to 1, which could be lowered if co-ops grew larger.[201] As for capital plant expenditures, the NRECA has encouraged members to ask if such expenses could be cut in half without loss of service.[202] Today, the average plant investment per customer has climbed to $4121.[203]

B. *Timing of Member Benefits*

When co-op distribution expenses are excessive, margins are less likely to be available to return to members although, with enough rate increases, even inefficient co-ops can generate positive margins. Since most states do not regulate co-op rates,[204] co-ops are free to raise rates until members revolt at annual meetings, a very difficult task. Whether or not the co-op is running efficiently, there are several ways of estimating whether a co-op has an adequate capital cushion.[205] The appropriate level of equity for co-ops depends on several factors including loan covenants, expected capital needs, and, of course, board discretion.[206]

The simplest financial test of a co-op's ability to benefit members is to determine the co-op's "equity as a percent of assets." According to RUS loan covenants, the minimum equity threshold is thirty percent, but the RUS recently waived this "current ratio test"[207] for all co-ops. The result is that

---

[199] CO-OP STATISTICAL REPORT, *supra* note 62, at 18.

[200] FRAMEWORK, *supra* note 27, at 35 ("Many co-ops are now considering mergers as a means to reduce costs and rates, because consumer size of a co-op is the most statistically significant indicator of a distributor's costs. For example, if a 3,000 member co-op merged to become a 15,000 member co-op, it could reduce costs by average of $220 per customer per year. Can we afford not to consider mergers?").

[201] Vital Signs, *supra* note 118, at 47.

[202] FRAMEWORK, *supra* note 27, at 34A.

[203] NRECA, Vital Signs, *supra* note 118, at 46.

[204] *See supra* notes 50, 51, 53, 70.

[205] The CFC boasts about its Key Ratio Trend Analysis (KRTA) statistical test, which includes 145 ratios of performance variables for each co-op for the last five years. *See* Press Release, CFC, 2006 KRTA Reflects Electric Co-ops' Consistent Financial Strength (Aug. 29, 2007) [hereinafter Press Release], *available at* http://www.nrucfc.org/news/pdfs/krta_press_release8-29-07_.pdf.

[206] NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 36.

[207] Memorandum from Blaine D. Stockton, Assistant Adm'r, Electric Program, Rural Utils. Serv., U.S. Dep't. of Agric., to All Electric Borrowers on Waiver of Provisions of RUS Loan Documents and Current Ratio Distributions (May 15, 2001), *reprinted in* NRECA & CFC, LEGAL SUPPLEMENT, *supra* note 23, at 14. *See also* Loan Security Documents for Electric Borrowers, 7 C.F.R. §1718.6.8 (2003); Post-Loan Policies and Procedures Common to

co-ops with equity levels far below thirty percent can refund capital credits. Today, distribution co-ops average 42.01% equity, but many are above 50% or 60% and some even reach 92%.[208] These data mean that, although co-ops can safely borrow more than two dollars for every dollar of equity, most co-ops are borrowing significantly less.[209]

Another threshold for co-op financial performance is TIER (times-interest-earned ratio), which measures co-ops' ability to pay interest on debt. The suggested appropriate TIER is 1.25.[210] Most co-ops today easily meet this threshold. The median electric co-op TIER was 2.29 in 2006, or nearly twice the financial strength that is required.[211]

These ratios indicate that co-ops are overcapitalized by roughly ten to thirty percent. Electric co-ops pass the "current ratio" and TIER tests so easily that the tests seem obsolete, which the recent RUS waiver of the current ratio test demonstrates. Individual co-ops vary but, in the aggregate, co-ops could offer one-time benefits to their owners of three billion to nine billion dollars without endangering co-op financial stability. Co-ops could also continue capital credit refunds at a higher level than today. In fact, such an enhanced refund policy would strengthen co-ops' tax and legal position as well as their relationship with customers.[212]

The irony of RUS loan covenants is that they were drafted to prevent co-ops from being too generous to their members.[213] Now the problem is often the reverse: not being generous enough. Equity is accumulating faster than co-ops are returning it to its rightful owners. Not even the blanket waiver of the "current ratio test" has induced co-ops to refund more capital. The "limited benefit to the co-op" principle is being stretched to the limit,[214]

Insured and Guaranteed Electric Loans, 7 C.F.R. §1717.617 (2006). Historically, according to Schmidt, "REA personnel have urged some of our clients [co-ops] to pay cash dividends to patrons when the members' equity was ten percent or less." Schmidt, *supra* note 123, at 174.

[208] Co-op Statistical Report, *supra* note 62, at 18. *See also* NRECA & CFC, Task Force Report, *supra* note 17, at 37 (noting that "[s]ome co-operatives have reached the conclusion that it is in the members' best interest to finance the co-op entirely through equity, while others would use 100 percent debt financing if possible. The best approach avoids either extreme.").

[209] *See* Frank W. Bacon et al., *Co-operative Debt Usage: The Case of Rural Electric Co-operatives,* Co-operative Accountant, Fall 1995, at 36 (finding that co-op debt levels have fallen substantially since 1980, and are lower in the Eastern U.S. than in the West).

[210] Rates to Provide Revenue Sufficient to Meet Coverage Ratios Requirements, 7 C.F.R. § 1718 subpt. C, app. A, § 5.4 (2006).

[211] Press Release, *supra* note 205, at 1.

[212] If co-op managers were able to designate five percent of capital credits for an anti-takeover fund to improve their own job security, co-ops should be able to return a higher percentage of capital credits to co-op members as refunds. *See supra* note 32.

[213] *See* NRECA & CFC, Legal Supplement, *supra* note 23, at 14.

[214] Because co-ops have accumulated twice the amount of capital required by regulators before the regulators waived the capital requirement entirely, co-ops seem to have built up greater reserves than any regulator, or customer, could have anticipated or intended. *See* NRECA & CFC, Task Force Report, *supra* note 17, at 35.

as is the tax-favored status of co-ops.[215] As the leading author on electric co-ops states:

> Any net margin of revenue over expenses is credited to members in proportion to their usage of electricity in the form of capital credits, or patronage capital. No interest is paid on this form of investment, but co-operatives are required to return this capital to their members. Size of margins and the timing of capital returns are key decisions for the board [of the co-op].[216]

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

> Co-ops can become much more competitive by simply revising their financial policies. *Reduce margins*. Maintain or *reduce equity*. Reduce general funds. Increase capital credit retirements to all members. These can make a big difference.[217]

The ability of electric co-ops to obtain virtually unlimited equity from their members, while retaining broad board discretion[218] as to when, if ever, members benefit from their ownership, has given them a government-like power to tax[219] and created co-op balance sheets unlike any others.[220] Some

---

[215] "The IRS has rarely challenged the business judgment of boards that fail to authorize capital credits retirements. At some point, however, capital accumulation may exceed any legitimate business need. If challenged by the IRS, this has the potential for serious consequences, such as the loss of co-operative status under federal tax law and member relations problems, which could lead to lawsuits to claim member capital or even action by members to sell the system in order to recoup their investment in the co-operative." *Id.* at 10, 54–58. *See also* Schmidt, *supra* note 123, at 175 ("The area of exemption from income tax and my advice to my clients became a source of irritation . . . . Briefly, a co-operative pays no income tax because legally it is a nonprofit. This means that the bylaws of the corporation must demand that the corporation divest itself of margins by turning the margins back to the customer, like a sales discount. According to the IRS, this means calculating the amount and notifying the members of the amount.").

[216] Public Utilities Reports, *supra* note 13, at 7, 83. "Patronage capital, capital credits, member equity—by any name, any co-op revenues in excess of expenses, or margins, are investments by the members in the organization and ultimately belong to the members and should be returned to them. Patronage capital is allocated to individual members based on the member's use of electricity, or contribution to margins. A co-operative member does not receive a return on this investment in the co-operative, other than the ability to buy power essentially at cost." *Id.*

[217] *See* Framework, *supra* note 27 (emphasis in original).

[218] Strait notes that "[i]n most cases, the board of directors of electric and telephone co-operatives have considerable discretion in redemption of capital credits. Their bylaws typically provide that redemption of capital credits is within the discretion of the board based on the circumstances and financial condition of the co-operative at that time. Therefore, capital credits allocated to utility patrons normally do not have a readily determinable value and thus do not give rise to income at the time of allocation." Strait, *supra* note 168, at 61.

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

co-ops operate almost entirely on equity, if only due to their board's distaste for debt. Equity is perceived as either costless[221] or extremely cheap.[222] Therefore, debt—even at subsidized interest rates—is co-ops' most expensive form of capital.

This upside-down world of co-op finance has created several anomalies. Co-op managers argue that returning any capital credits to members, or reducing any New Deal subsidies, would force them to raise electric rates unnecessarily.[223] Co-op managers are essentially saying that any change in the status quo would harm members. This argument, though it sounds persuasive, is flawed. It assumes that all co-ops are efficient and should be able to continue their current practices—practices which amount to confiscating member equity.

The ultimate issue in co-op refund policy is intergenerational fairness. As the NRECA says, "retiring capital credits is a way to ensure that each generation of members pays its own way by providing its own equity."[224] But co-op managers naturally tend to favor new customers over old, knowing that older customers have already paid a lifetime of margins and are powerless to reclaim them. Co-op managers are motivated to boost sales to new members and those with future buying power.[225] If co-ops offer refunds

---

[220] *See* Claudia Phillips, *Revisiting Equity Management–The Art of Wise Compromise*, MGMT. Q., Winter 2001, at 24.

[221] WILLIAMS, *supra* note 14, at 130. ("Some people said it was zero cost capital and that you shouldn't give back zero cost capital, only to borrow at 7 to 10 percent . . . [but] we have to return capital to the membership. We just can't keep it indefinitely.") *Cf.* Wesley M. Jackson, Assistant Chief, Distrib. Mktg. Branch, Testimony to Capital Credits Study Comm. 3 (Oct. 1, 1974) (noting that "[t]he refund to members of their capital contributions deprives the co-operative of interest-free equity capital. It increases the cost of doing business . . .").

[222] NRECA appears to be on the defensive on this key issue. *See* NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 36 ("Since a co-operative is not allowed to pay a return on equity contributed by its members, some people say that the cost of equity to a co-operative is zero, but that is incorrect. The Goodwin formula offers a more realistic view. It calculates the return on equity a co-op must earn to maintain equity at a given level while meeting growth needs and retiring capital credits. It shows that there is a cost of equity even for a co-op experiencing very low growth."). NRECA's reasoning is specious, however, because co-ops may use members' margin payments indefinitely, and without cost to the co-op. The Goodwin formula also falsely implies that faster-growing co-ops have a higher cost of capital, simply because they are growing, when such co-ops have access to more such margins.

[223] The manager of Duck River Electric Membership Co-operative, Jim Allison, said that "if DREMC were to reduce its equity to 40 percent . . . it would require the utility to raise its electric rates to compensate–robbing Peter to pay Peter, as it were." John I. Carney, *DREMC official responds to Cooper equity comments,* SHELBYVILLE TIMES-GAZETTE, April 12, 2004, at 1. However, any rate increases that a more generous refund policy could cause would be small, if not negligible. One article found that another Tennessee co-op could refund $366 to each of 150,000 customers while maintaining equity at forty percent. Assuming the co-op borrowed the amount of the refund, it would cost each ratepayer 50 cents per month. Snyder, *supra* note 35.

[224] NRECA & CFC, TASK FORCE REPORT, *supra* note 17, at 10.

[225] "Last-in, first-out" or LIFO refund policies return the margin payments of the newest customers first, retaining older customers' capital credits longer. Under the "percentage" method, both new and old customers receive refunds, according to the fraction chosen. *See* WILLIAMS, *supra* note 14, at 133 ("You might as well burn the money in terms of what it does for your co-operative [by refunding capital credits to old customers]. By retiring capital cred-

at all, co-op managers increasingly favor "last in, first out," or "percentage-based," refund plans that favor newer customers.[226] Decreasing the benefits distributed to long-time customers subsidizes newer customers with the older customers' equity.

C. *Ways of Benefiting Members*

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

Lowering electric rates benefits members according to their future usage, but rates are very difficult for members to monitor and compare. Most members do not track their bills year-over-year closely enough to appreciate a reduction in millage rates.[227] Lowering electric rates also reduces incentives for conservation.[228] Finally, without knowing the size of a member's capital account, it is also hard to compare the rate reduction to member equity.

Lowering the volume of electricity purchased is ultimately up to the customer, not the co-op, although higher rates for electricity at times of peak demand can influence customer decision-making. Co-ops often underestimate the need for conservation which, according to some utility experts, is seventy-five percent cheaper than new base load generation.[229] The co-op is uniquely able to educate customers on the costs and benefits of better home insulation, more efficient bulbs and appliances, or timing the use of appliances at night.[230] Digital readout meters or even a more visible meter loca-

its on a percentage basis, we felt that current members would see a rebate now, an ownership interest in the system, and better understand the philosophy of co-operatives. If they had to wait 20 or 30 years to get their patronage capital, they wouldn't get the same feeling.").

[226] *See id.* at 41 (showing that 36% percent of co-ops use one of these refund methods, as opposed to 41% percent for FIFO).

[227] Customer-friendly billing software could help members compare, for example, rates in August 2008 with those from August 2007. This could help customers compare their electricity usage during similar seasons.

[228] Some studies have estimated that the elasticity of demand for electricity is -1.0, meaning that a 25% drop in rates would result in a 25% increase in consumption. Michael T. Maloney & Robert E. McCormick, Issue Analysis: Customer Choice, Customer Value—Setting the Record Straight: The Consumer Wins with Competition 8, Citizens for a Sound Economy, Jan. 30, 1997.

[229] Letter from Tom Kilgore, President and CEO of TVA, to author (March 14, 2008) (on file with the author).

[230] In its 2006 Annual Report, NRECA presented statistics about co-ops' promotion of energy efficiency and conservation, such as "92% [of co-ops] actively educate consumers on energy conservation" and "41% offer weatherization services," but did not indicate how effective these education or weatherization opportunities are. NRECA ANNUAL REPORT, *supra* note 138, at 22.

tion can help customers understand how much excess electricity they are consuming.

The best way to achieve "at cost" electric service is, as the NRECA agrees, increased return of capital credits to co-op members. In 2006, $499 million of electric co-ops' $31 billion in patronage capital was returned,[231] although many co-ops, including some of the most prosperous, never return any credits.[232] Co-ops that make refunds should also disclose the size of a member's remaining patronage account in order to improve co-op accountability.[233] An interesting question is whether members should also be able to benefit more directly from the $3.9 billion investment that co-ops have made in CFC, itself a co-operative that is wholly owned by co-ops.[234]

An indirect benefit to members—as well as the public—is reducing the environmental harm that power generation inevitably produces.[235] Burning coal produces pollutants such as mercury, sulfur dioxide, nitrogen oxide, and particulates, which harm the region surrounding the power plant and beyond. Another form of pollution, carbon dioxide, affects the global environment. Of course, most other energy sources pollute as well,[236] whether CO_2 from natural gas or long-term radioactive waste storage for nuclear plants.

Some co-op managers are glossing over the environmental impacts of their decisions and exerting their political influence to exempt co-ops from laws that apply to other utilities. Montana and Virginia co-ops recently lobbied their U.S. Senators to allow a twenty-year delay in complying with new pollution control standards.[237] They argued that avoiding national pollution

---

[231] *See* NRECA, About Us, http://www.nreca.org/AboutUs/Co-op101/Co-operativeFacts.htm (last visited Mar. 9, 2008). Co-ops are not required to file Form 1099 to report payments of capital credits, except for business customers (who presumably have deducted their purchases of electricity, unlike residential customers). *See* James Howard Smith, *IRS Proposes Examination Guidelines for Rural Electric Co-operatives*, CO-OPERATIVE ACCOUNTANT, Fall 1996, at 32.

[232] The largest co-op in America, Pedernales Electric Co-operative, had not paid one until scandal forced them to this year. Claudia Grisales, *Pederanales Execs Plan to Step Down*, AUSTIN AM.-STATESMAN, Nov. 14, 2007, at A1.

[233] The ratio of the member's refund to the remaining balance of the member's capital credits account determines the member's return on his or her investment, loan, or contribution. *See supra* note 153. Ideally, the co-op would help the member understand how much a delayed return of equity has cost the member due to inflation. *See supra* notes 161, 222.

[234] *See* NATIONAL RURAL UTILITIES CO-OPERATIVE FINANCE CORPORATION, 2007 CFC ANNUAL REPORT 8 (2007).

[235] Co-ops have been aware since at least the mid-1990s that "the environmental impact of electric generation [is] a national concern." WILLIAMS, *supra* note 14, at 151.

[236] New hydro power requires dam construction, interrupting free-flowing streams and often depleting oxygen levels in lake water. Wind power generates noise pollution and harms bird migration. Solar power may involve toxic substances in its manufacture. As of the mid-1990s, co-ops owned "over 3,000 megawatts of operating nuclear capacity in 15 plants." *Id.* at 173.

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

control requirements is more valuable than cleaner air to their members.[238] It is unknown whether co-op managers considered the damage to customer health that increased and prolonged pollution can cause. It is unlikely that co-op members were aware of the decision by co-op managers to lobby on their behalf, and possibly against their interests.

V. Strategies for Change

There are a number of ways that co-ops could return to their pro-consumer roots, but each will require a radical change in the attitude of co-op directors and managers. These co-op insiders have benefited most from the erosion of co-operative principles and will probably be the chief obstacles to reform.[239] This is a classic "principal-agent" problem because the principals (co-op members) are unable to control their agents (co-op directors and managers), in part due to collective action problems and prohibitive monitoring costs. These agents have entrenched themselves in their control of the co-ops and sometimes run the co-ops to the detriment of the members' best interests. The situation is so severe that even the agents' agents, namely the NRECA and CFC, seem to be quietly siding with the principals.[240] Because it is unlikely that co-op insiders will voluntarily change their behavior, even at the urging of their own advisors, legislation will be necessary.

Restoring the original mission of co-ops—i.e., "at cost" service, including the costs of electricity waste and pollution—will require the following legislative steps:

- Operations: Increasing co-op minimum size in order to promote efficiency and conservation; analyzing future power demand.
- Governance: Mandatory disclosure of membership interests, a grading system so that members can easily evaluate co-op performance, and, at least for larger co-ops, making membership interests securities. Taking co-ops public is one way to achieve all of these objectives by vote of the membership.
- Subsidies: After seventy years of subsidies, only co-ops that need government help should receive it. Threatening to withhold federal assistance will also aid compliance with the preceding co-op reforms.

A. *Operations: Optimizing Co-op Size*

In the short term, increasing the number of each co-op's customers means either expanding service areas or combining with another co-op or

---

[238] *Id.*

[239] The author's access to NRECA's and CFC's password-protected website, www.cooperative.com, was terminated by late March, 2008.

[240] NRECA publications and The CFC Story have adopted a critical but polite tone towards co-op business practices. *See, e.g.*, *supra* notes 25–27, 69, 137. NRECA speeches, in contrast, are very diplomatic, often pandering. *See, e.g.*, *supra* notes 24, 58, 59, 64, 100.

power company, either by merger or acquisition. Other co-ops are the most obvious merger candidates,[241] but co-ops should not neglect opportunities to merge with munis or telephone co-ops; both are already community-owned and may provide more synergy. Munis have higher customer density as well as smaller average size, making them ideal takeover targets if local governments can be persuaded to relinquish ownership.[242] Of course, sometimes the merger should go the other way, with munis acquiring co-ops. It will be interesting to see whether members care enough about belonging to a co-op to revive its atrophied features, or whether "municipalization" (i.e., becoming a taxpayer without equity in the local power company), is sufficient. For small patronage-capital holders, the debate is academic; for large accounts, mergers could unlock a lot of value.

The most aggressive bidders for co-ops may also be neighboring IOUs, although co-ops are also capable of acquiring IOUs.[243] IOUs are usually much larger than co-ops and more accustomed to acquisitions. Allowing takeovers from outside the public-power "family" is controversial, but suburban co-ops already have much in common with IOUs. The principle of "member benefit" should guide any such transactions, just as "shareholder benefit" theoretically guides corporations.

The rapid decline in the number of telephone co-operatives in recent decades is an indication of the merger potential of electric co-ops, particularly if their local monopolies erode.[244] There were 878 rural telephone co-ops in 1980, but only 227 today.[245] Over the same time period, the number of electric co-ops has declined only from 1,020 to 930 because electric monopolies remain robust.

---

[241] A few co-op mergers are taking place, with significant savings for members. *See, e.g.*, Lauren Donovan, *Consolidated Co-op OK'd*, BISMARCK TRIB., Dec. 8, 2007 *available at* http://www.bismarcktribune.com/articles/2007/12/08/news/local/144061.txt (merger of Oliver Mercer Electric Co-operative with West Plains Co-operative, member savings projected at $5 million over 10 years); Jannette Pippen, *Opinions Mixed on Possible Co-op Merger*, DAILY NEWS (Jacksonville, N.C.), Nov. 26, 2007, *available at* http://www.jdnews.com/news/island_53516___article.html/harkers_merger.html (merger of Carteret-Craven Electric Co-operative with Harkers Island Electric Membership Co-operative, member savings projected at $6 million over 10 years). For an earlier example of a co-op merger, see Shane Adams, *The Merging of Two Electric Membership Co-operatives*, CO-OPERATIVE ACCOUNTANT, Fall 1999, at 76.

[242] *See* RON NICHOLS, NAVIGANT CONSULTING, COST SAVINGS FROM ALTERNATIVE COMBINATION OF MUNICIPAL LIGHT & POWER AND CHUGACH ELECTRIC ASSOCIATION (2007), http://www.muni.org/iceimages/mayor/ACF1471.pdf (last visited Feb. 8, 2008) (demonstrating several ways of combining a co-op and a muni; also projecting savings of as much as $218 million over 10 years).

[243] *See* PUBLIC UTILITIES REPORTS, *supra* note 13, at 167–168.

[244] Deregulation of the telecommunications industry fostered the formation of the competitive local exchange industry ("CLECs") comprised of smaller telephone companies which have consolidated and offered enhanced telecommunications services. Not all have been successful. The New York firm Forstman-Little invested $1.2 billion in McLeodUSA, a rollup of telephone co-operatives and other carriers that resulted in bankruptcy. Adam Lishinsky, *How Teddy Forstmann Lost His Groove*, FORTUNE, June 26, 2004, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2004/07/26/377149/index.htm.

[245] *See* TELECOMMUNICATIONS STATISTICAL REPORT, *supra* note 12.

More efficient co-ops will result in lower members' bills. Most co-ops have experimented with other lines of business than electricity, with mixed success.[246] Co-ops could have concentrated on their core business instead by finding new ways to benefit electric customers. Conservation directly benefits members and does so in the amount of the members' own choosing. Every co-op should be mandated to promote conservation in ways that have proven to be effective.[247]

Of course, conservation will also slow the growth of co-op sales. Co-op managers have been paid to boost consumption for so long[248] that they have naturally been slow to innovate with variable-price electricity, time-of-day meters, remote monitoring of meters, and prepaid electricity cards. These and other demand management techniques should be promoted by co-ops in order to put members first. Once co-ops have lowered members' bills, they should be allowed to continue venturing into other lines of business that are appropriate for co-ops.

Co-ops should be extremely wary of the effort to take advantage of co-ops' superficially strong balance sheets in order to finance a particular energy industry's new mode of power generation.[249] Most co-ops lack the expertise to make such a commitment to coal or any other fuel, and their capital should be for the benefit of members, not energy companies. Co-ops over-invested in new generation capacity in the 1970s, resulting in wasted capacity and bankrupt co-ops.[250] Co-ops are unusually dependent on coal-fired steam plants, relying on them for eighty percent of their power versus fifty percent for IOUs. As a result, co-op decisions about new generation capacity may be biased toward coal. Some investment in coal-fired steam plants may be necessary, but co-ops are not able to decide such questions without thorough research and the approval of their members, after careful consideration of the environmental impact.

---

[246] *See, e.g.*, Wallace F. Tillman, Moderator, *How Can Your Cooperative Meet the Legal Challenges of Restructuring and Diversification,* NRECA 1999 Annual Meeting, Monday, March 8, 1999, PowerPoint Presentation (on file with author).

[247] NRECA survey data of 88% of co-ops offering renewable energy, 77% offering energy-savings audits, etc. do not reveal how effective these offers have been. More persuasive are the 49% of co-ops that offer financial incentives for customer efficiency/conservation, or the 37% that have direct control over some members' appliances, or the 40% that have advanced metering devices. Still, even these numbers do not reveal how much electricity waste is reduced. Getting all utilities to share best practices should enable co-ops to regain their credibility as the most consumer-friendly of the power companies in regard to conservation. *See* Nreca Annual Report, *supra* note 138, at 22–23.

[248] In the same NRECA Annual Report, conservation is relegated to the last two pages of the Report, despite the phrase, "Co-ops aggressively promote energy efficiency and conservation." *Id.*

[249] The NRECA 2006 Annual Report reads like coal industry promotion, particularly the opening letters from the Chairman and CEO. *Id.* at 1, 3. The bankruptcy of Sunflower Electric Co-operative was caused by construction of an unneeded 280 megawatt coal-fired steam plant. *See* Williams, *supra* note 14, at 229.

[250] *See* Public Utilities Reports, *supra* note 12, at 104; *see also supra* note 63.

B. Governance: Empowering Members

Once co-ops are large enough to be efficient and more focused on serving their members' needs, co-op members must be enabled to protect their own interests. Empowerment is better than rate regulation by state utility commissions because it enhances "The Co-op Difference." Empowerment begins with requiring all co-ops to disclose each member's equity stake at least annually and easing member access to their capital credits. Every co-op with a strong balance sheet should return some credits.[251] This would reinforce NRECA's own advice and could be achieved at low cost since co-ops already have the software and monthly contact with customers to return capital credits efficiently.

In addition, a simple grading system should be developed so that all members can easily evaluate their co-op's relative performance against their peers by using benchmarks that are appropriate for co-ops. To further empower members, Congress should pre-empt the portions of state electric co-op laws relating to proxy voting and quorum requirements so that members can better defend their own interests at annual meetings. These changes should be sufficient for all but the largest of co-ops which, due to their similarity to IOUs, must do more to protect member interests.

The risk of the disclosure approach is that many newer co-op members would still not consider their ownership stake large enough to be worth the effort to obtain and analyze co-op information, and that many older members, even with large accounts, might remain passive. For this reason, at least for larger co-ops, capital credits should be made "securities" under the federal securities laws.[252] Alert judges should already realize they are securities, but it will probably be necessary for Congress to clarify the Securities Act of 1933, which fudged the issue. Trial lawyers would jump at the chance to seek damages under the securities law for co-op abuses of member rights.

---

[251] This advice is hardly new to co-ops. *See* Strait, *supra* note 168, at 62 ("To engender member loyalty and attenuate possible take-over threats, some utility co-operatives are considering patronage capital redemption approaches already used by other types of co-operatives. Electric and telephone co-operatives with strong equity balances are considering whether or not the redemption cycle for capital credits can be shortened. Others are examining whether the traditional first-in, first-out redemption approach to a base capital plan, percentage-of-all-equities redemption plan, or another plan which results in earlier redemption to current patrons.").

[252] "The larger the co-op, the more it looks like a public company. So the more you would expect it to follow public company norms in terms of its governance." Grisales, *supra* note 193 (quoting Charles Elson, John L. Weinberg Center for Corporate Governance, University of Delaware). *See also* Frank A. Taylor, *Are Financial Instruments Issued by Agricultural Co-operatives Securities?: A Framework for Analysis*, 5 DRAKE J. AGRIC. L. 171 (2000) (discussing agricultural co-operatives and securities); Kathryn J. Sedo, *The Application of Securities Laws to Co-operatives: A Call for Equal Treatment for Nonagricultural Co-operatives*, 46 DRAKE L. REV. 259 (1997) (same); William E. Van Valkenberg & Robert G. Bergquist, *Securities Law Update: Reves v. Ernst & Young*, CO-OPERATIVE ACCOUNTANT, Summer 1990, at 36 (arguing that demand notes issued by a co-operative are securities under federal law).

Litigation would lead to instant co-op reforms, but attorney fees and court costs would be high.

Fortunately, an elegant and voluntary means of empowerment exists that also avoids litigation. Informed co-op members should vote to take their co-op public on the NASDAQ stock exchange.[253] Although initial public offerings sound radical to incumbent co-op managers, this way of unlocking shareholder value is commonplace in the business world. Unfortunately, because so few co-op managers are familiar with the process, it looks more threatening than it is. Essentially, members would be choosing to turn their capital credits into securities that are traded on the stock exchange.

The widespread conversion of mutual insurance companies, savings and loan associations, and credit unions to stock companies shows that member rights can be enhanced by floating shares in public markets.[254] Of course, when poorly handled, such conversions can disproportionately benefit insiders. Nevertheless, this abuse can be avoided if careful attention is paid to the terms of the offering. The key benefit of conversions is that a member's ownership becomes instantly visible, liquid, and priced to the market every day. No member would have to sell their stock after such an offering; in a well-run co-op, no one would want to. Voluntary conversion allows members to decide what is best for themselves and their property, ending the paternalism of co-ops' current method of operation.

C. Subsidies: Means-Testing Co-ops

The final co-op reform is the most obvious and overdue. If federal aid were restricted to the co-ops that truly needed help, and suburban co-ops were left to fend for themselves, federal taxpayers could save money and improved co-op management might result.[255] Means-testing co-ops will almost certainly be bitterly resisted by co-op managers, but co-op members themselves would probably not be so critical. Most Americans claim to be opposed to government waste; they know it does not make sense to subsidize utilities that serve wealthy counties,[256] whether they are IOUs, munis, or co-ops. Removing federal subsidies for co-ops would strengthen the argument for dismantling the larger subsidies for IOUs and munis. Selective removal could also be an effective enforcement tool against co-ops that refuse to become more efficient or member-friendly.

---

[253] The author participated as an investment banker in one such effort to take a telephone co-operative public in 2000. *See* DTC Commc'ns Corp., Prospectus (Rule 424(B)(3)) (Jan. 11, 2000), *available at* http://www.sec.gov.

[254] *See* Weisbrod, *supra* note 16, at 129–150.

[255] The Bush administration has proposed that each co-op recertify its rural status before new loans can be made to it by the RUS. *See* Office of Mgmt. & Budget, Appendix to the Budget of the United States, Fiscal Year 2008, at 146 (2007).

[256] A key advisor in the formation of CFC said, "Any subsidy [to co-ops] should be justified on the basis of national interest involved, such as the immense task of rural development." Williams, *supra* note 14, at 38–39.

A tougher question involves the possibility of removing tax-favored status from wealthy co-ops that, for example, no longer serve rural areas, refuse to keep open records, fail to refund capital credits, or have diversified far outside the electricity business. Many co-op managers view tax-favored status as a permanent entitlement instead of a special incentive to provide public goods. Revising co-op tax status for prosperous co-ops would also allow legislators to consider removing the tax subsidies from other power companies.

VI. Conclusion

Too many electric co-ops have turned away from their historic role as exciting, pro-consumer organizations and have instead taken on deeply troubling anti-consumer behaviors. Ideally, co-ops will return to their roots voluntarily, but a legislative push will likely be necessary. Carefully considered, member-friendly reforms are long overdue in order to protect the rights of the co-ops' legal owners, including members' rights to receive refunds of $3 billion to $9 billion of capital credits. In addition, the conservation and environmental impact of co-op decision-making must be considered. It is time for members to take back their property and their co-ops, for the good of themselves and their country.