Consolidating Co-Ops

Like it or not, changes are coming for electric cooperatives. Fewer and bigger might be the inevitable result.

BY MICHAEL T. BURR

When power planners at Basin Electric Power Cooperative began trying to decide how and where the company's next big power plant would be built, they did what a co-op does best—they reached out and formed a coalition.

Early this year, Basin joined with three other utilities—one investor-owned and two municipals—to conduct a joint transmission study that would help determine the best location for a new, 600-MW coal-fired power plant, and possibly a 100-MW wind farm.

"The coalition was formed to capture the economies of scale that are necessary to provide low-cost, reliable power, and to help mitigate the risks associated with developing a large resource," Hill says.

Combining efforts to serve an aggregated load is the name of the game for Basin, which generates power for 125 member co-ops from northern Montana to southern New Mexico. As such, Basin is a super-cooperative, created by a group of generation and transmission (G&T) co-ops to own and operate power plants to serve dozens of small distribution co-ops.

Basin Electric exemplifies the very best of G&Ts and the co-op model in general. The company is one of several noteworthy examples of co-ops banding together to form a greater—and more efficient—whole.

At the same time, however, most electric co-ops remain fundamentally small, local entities. Therein can be found a long-standing source of their strength. "The consumers own the business," says Glenn English, CEO of the National Rural Electric Cooperative Association (NRECA) in Arlington, Va. "Decisions are made by the members' elected board directors. In many ways, it's like our democratically elected government. If you don't like the policies, you elect a new administration."

Co-ops' local control, however, might be limiting their ability to fulfill their primary mission—namely, to provide reliable electricity service for the lowest possible cost. Some analysts argue that co-ops are wasting their customers'/owners' money by failing to consolidate and economize administrative costs. Furthermore, the local-control argument might no longer carry the weight it once did.

"The idea of a co-op was great in the '20s and '30s, when electricity wasn't extended out to everyone," says Ed Tirello, managing director and senior power strategist with Berenson & Co. in New York. "But now suburbia has moved out to the rural areas. You have a lot of co-ops that are serving urbanized

America, and their costs remain high because they have fewer customers."

A confluence of forces—political, market, and economic—may be putting pressure on co-ops to consolidate and update their business approaches. If these forces persist, the typical co-op of the future will have much more in common with Basin Electric than it does with the small, insular co-ops of today.

Power to the People

If the U.S. Congress ever gets around to repealing the Public Utility Holding Company Act (PUHCA), the nation's 100-odd investor-owned utility holding companies might quickly consolidate into Ed Tirello's famous 50. After all, the 10 biggest utilities already sell about 30 percent of the country's electricity.

Yet at the same time, the utility industry's unseen majority operates much as it has for decades, swarming like mice around the ankles of mammoth IOUs. The ranks of electric cooperatives total more than 900, a number largely undiminished by mergers or acquisitions.

Co-ops own and maintain 43 percent of the distribution lines in the United States, covering three-fourths of the country's real estate and serving eight of every 10 counties. In terms of density, of course, co-ops are tiny, with less than 7 consumers per mile of line, compared with 34 for IOUs. In all, less than 12 percent of U.S. electric consumers get their power from co-ops.

But despite the diminutive size of individual co-ops, *en masse* they represent a powerful force. The operations budget of the NRECA exceeded $134 million in 2002, and the co-ops' political action committee is among the 50 largest in the country.

If co-ops carry a lot of weight at the national level, it's probably because they have served rural communities consistently for nearly 70 years. "The premise is the same as it was in the '30s and '40s: Provide safe, reliable power at the lowest possible cost to the people who actually own the utility: the consumers," English says. "Our basic objective is different from that of an IOU. Where the objective of investor-owned utilities is to maximize profits, the objective of cooperatives is to minimize costs. That's the secret to the longevity of co-ops."

Additionally, co-ops are advocates for rural communities, serving as an organizing force to support local economic development and represent the interests of rural communities at the state and federal level. "It's not just a political thing, but also about sustainable development," says Michael Zimmer, a partner with Baker & McKenzie in Washington, D.C. "Co-ops are a tool for attracting new business to remote areas that don't have as much going for them politically and economically as metropolitan Minneapolis or Omaha."

Co-ops also are differentiated from IOUs by their universal service obligation. This affects the way they are regulated and how they make pricing and investment decisions. To stretch the extra mile in bringing electricity to remote customers, cooperatives historically have greater flexibility than IOUs in making investment decisions and setting rates.

Accordingly, except in a couple of states, co-op rates are not regulated by state PUCs but are determined by co-ops' local board directors. "Co-ops can have different rate products and classes of service to meet the needs of customers, compared to the rigidity of a rate-regulated system," Zimmer says.

In practical terms, the heavy lifting of rural electrification was accomplished decades ago. However, the Rural Utilities Service (RUS) continues financing rural utility infrastructure, investing nearly $4 billion last year. Through the RUS, co-ops can access loans at subsidized interest rates far lower than the

market-rate capital available to IOUs.

RUS debt, however, is not the only source of funds for co-ops. Cooperatives earmark part of their members' monthly bills as "patronage capital"—the equivalent of equity funds, which are used to finance co-op investments. "You sort of buy your way in," says John Lange, a senior vice president with Lehman Brothers in New York. This type of equity funding is very economical because co-ops do not pay interest or dividends on it.

This low-cost equity helps co-ops to minimize their debt loads and minimize financing costs. In recent decades this has allowed co-ops to begin accessing other financing sources—namely, registered public debt, which offers freedom from the tight restrictions and long turnaround times that typify federally funded RUS loans. But because most co-ops are too small to swim in the deep waters of Wall Street, they link together and float bonds through a national financing cooperative—the National Rural Utilities Cooperative Finance Corp., or CFC for short.

"The premise is simple: We package together co-ops' needs, go to the capital markets with short-term, intermediate, and long-term securities, and use those securities to provide loans to cooperatives," says Sheldon Petersen, CFC's CEO. "We can provide 30- to 40-year terms, which the banking community doesn't do, with a lower cost of access." CFC's investment-grade credit rating (A/stable) allows the company to access the debt markets at attractive rates. In total, CFC has $21 billion of assets, of which about $15 billion represents loans to electric cooperatives.

Also, most co-ops enjoy tax-free status as not-for-profit organizations. This feature, combined with federal funding, member contributions, and relatively cheap debt, has helped to keep most co-ops financially strong despite low customer density.

Rising Pressure

To further buttress their strengths at the national and regional levels, co-ops in recent years have begun attempting to combine their efforts in new ways, beyond the advocacy and financial initiatives of the NRECA and CFC. These efforts have yielded mixed success, due in part to the fragmented and locally focused nature of co-ops.

In 1998, a group of about 550 cooperatives formed a nationwide alliance, Touchstone Energy, to provide retail-marketing resources for co-ops that were expecting to face retail competition. Touchstone's major contributions today include advertising in print and on TV, and a bill-consolidation program for co-ops' commercial and industrial customers.

"The idea with Touchstone was to create a prominent national brand and a unified message across the United States," says Kevin T. Williams, an attorney in Hendersonville, Tenn., and formerly in-house counsel for Old Dominion Electric Cooperative in Virginia. The unified brand never fully developed, in part because competitive pressures subsided, but also because co-ops in general did not embrace the concept. "Mostly what you have now is a loosely coordinated customer-referral program," Williams says.

A more vibrant retail market might make that opportunity appear more significant for cooperatives, but in general they have resisted retail deregulation efforts—opting out of retail competition in states like Texas, which provided that option, and actively lobbying against it in many cases.

Yet while the specter of retail competition has receded for co-ops, wholesale market pressures have intensified. As a result, the co-ops' other major marketing effort—ACES Power Marketing (APM)—is becoming a powerful force in wholesale trading.

Indianapolis-based APM is among the top five energy traders in the country, executing more than 100,000 transactions for its members and customers in 2003. APM acts as an agent for its 14 member cooperatives and other customers, which include municipal utilities, independent power producers, and banks that find themselves holding surrendered merchant capacity. In all, APM is responsible for managing 15,000 MW of generation and 25,000 MW of load in the wholesale markets.

"Everything APM does is for hedging, not speculation," says David J. Tudor, APM president and CEO. "We are ultimately owned by the consumers that own our member co-ops, and we have no business risking the consumer's money on speculative activity." APM provides its services at cost to member co-ops, with a small markup for other customers. "The structure of the co-op program calls for this business plan," Tudor says.

Part of APM's business involves representing its member cooperatives in regional transmission restructuring proceedings, including ongoing meetings at the Midwest ISO, the Southwest Power Pool (SPP), and ERCOT in Texas.

"If you are not participating in the sessions to establish the rules, they can negatively affect you, both operationally and financially," Tudor says. "There are significant issues around congestion and load, how zones are established, and how the load affects the value and cost changes in each portfolio. Operating in a deregulated wholesale market during this transition period is very risky and complicated."

A key operational challenge is the fact that market participants must update their automation and software systems to comply with the new systems being created by the RTOs. This requires a significant financial commitment from co-ops, particularly those that might trade in more than one market.

"The tagging system that is used to schedule power is being replaced with a new market design," Tudor says. "ERCOT, MISO, and SPP are all taking a similar approach, based on PJM, but they're not exactly the same. So you end up with more than one way that you must be able to operate and manage your software."

Such factors are forcing co-ops to work more closely together than is usual for them. "It is forcing allegiances between co-ops, as well as municipals and other load-serving entities," Tudor says. "They have to work together to protect their competitive positions."

Boiling Down

Concurrent with increased pressure from market shifts, some co-ops are beginning to feel the heat of regulatory and competitive pressures. One of the hot spots is the state of Tennessee, or, more generally, the region served by the Tennessee Valley Authority (TVA).

Most co-ops refund patronage capital to customers over time. Cooperatives operating under the jurisdiction of the TVA, however, are prohibited from returning patronage equity.

"TVA is an unusual case," English says. "They have this agreement that prevents them from returning capital credits. TVA wants to make sure rates are as low as they can be, and someone isn't charging more on the distribution level so they can pay out capital credits." In other words, TVA expects its cooperatives to use excess capital to reduce power rates.

Indeed, power rates are low across Tennessee, thanks to the availability of cut-rate TVA power supplies. But questions are being raised about whether rates for Tennessee co-ops are as low as they could be, and about how much patronage capital is tied up in the cooperative system.

"I think co-ops should disclose what each customer owns

Fig. 1 — Co-Op/IOU Defections

A. Co-op Buyouts by IOUs

Co-op Acquired	State	Acquiring IOU	Year
Cajun Electric Power Cooperative	La.	NRG Energy (formerly Northern States Power)[1]	2000
Big Rivers Electric Corp.[2]	Ky.	LG&E Energy Corp.	1998
Teche Electric Co-op	La.	Cleco	1997
Colorado-Ute Electric Association[3]	Colo.	PS Colorado	1991
Bossier Electric Membership Co-op	La.	Southwestern Electric Power (now AEP)	1993
Prairie Power Co-op	Idaho	Idaho Power	1992
Glacier Highway Electric Association	Alaska	Alaska Electric Light & Power	1988
Shoshone River Power Inc.	Wy.	Pacific Power & Light (now Scottish Power)	1985

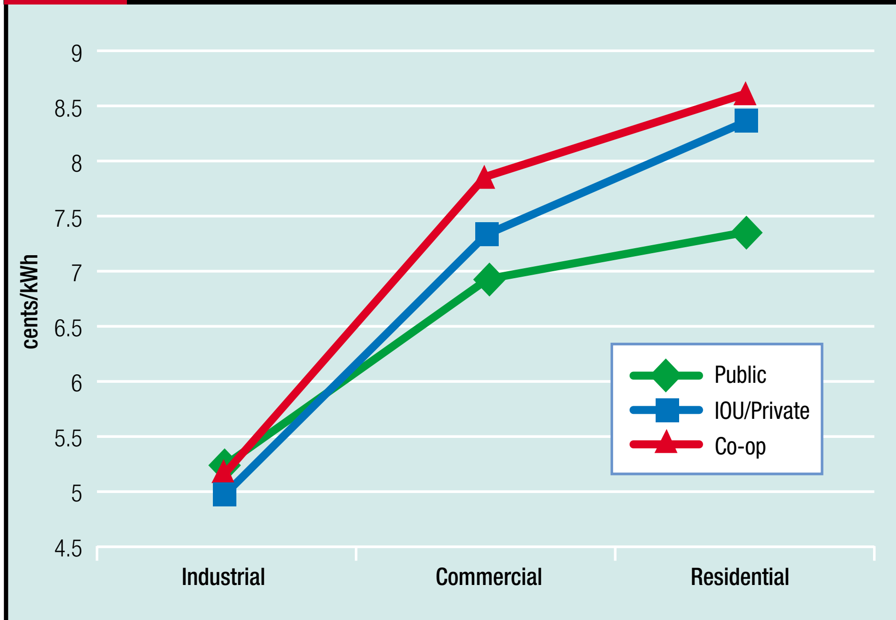
B. Utility Buyouts by Co-ops

Utility Acquired	State	Acquiring Co-Op	Year
Vermont Electric (Citizens Utilities)	Vt.	Vermont Electric Co-op	2004
Kaua'i Electric (Citizens Utilities)	Hawaii	Kaua'i Island Utility Co-op	2002
CP National	Ore.	Oregon Trail	1988

1. Louisiana Generating LLC was a subsidiary of NRG Energy, itself a wholly owned subsidiary of Northern States Power at the time of the Cajun acquisition. NRG acquired Cajun's fossil-fired power plants out of Cajun's bankruptcy liquidation. Louisiana Generating became co-ops' wholesale power provider. Also, in 1996 the Rural Utilities Service transferred Cajun's 30 percent interest in the River Bend nuclear station to Entergy.
2. Lease of generation assets as part of bankruptcy reorganization; Big Rivers remained power supplier via contractual arrangement.
3. PS Colorado acquired 332 MW of generating capacity and four co-ops' wholesale power-purchase contracts as part of bankruptcy reorganization; PacifiCorp also purchased 243 MW of generating capacity.

Sources: Intersection LLC; Kevin T. Williams, Atty. at Law

Fig. 2 — Average Utility Rates (2002)



Sources: Intersection LLC research; APPA

as soon as possible," wrote Rep. Jim Cooper, D-Tenn., in a guest editorial appearing in the April 12, 2004, edition of the *Tennessean* newspaper.

Cooper's hackles were raised when he realized that Tennessee co-ops were carrying an inordinate amount of patronage capital. In some cases, patronage equity makes up nearly 70 percent of co-op assets in Tennessee, compared to the national average of 43 percent. Yet the average Tennessee co-op customer/owner is unaware of this fact, and would be unable to learn the value of his or her patronage stake because the co-ops don't report that information.

Cooper further noted that only 2 percent of Tennessee co-op members participate in annual elections, and called for greater accountability in general. "Government barely regulates co-ops because of the assumption that [co-op owner/members] are policing them through annual elections of co-op directors," Cooper wrote.

Too Many Co-ops?

Cooper is one of the few politicians to publicly call co-ops to the carpet, but in policy circles, the unregulated nature of co-ops has caused some discomfort.

"Politicians in general would rather have co-ops regulated by the same entities that regulate other utilities," Tirello says. "The rules should be the same for everyone. It's better for the consumer and ultimately for the industry."

Furthermore, security and reliability issues are raising the stakes in the regulatory game. The fragmented nature of co-op systems might be complicating the tasks of regional coordination, control, and communication.

"The simple fact is there are too many co-ops," Williams says. "Co-ops are balkanized and inefficient. If co-op directors weren't so attached to their local control and perks, co-ops would consolidate into a more rational number."

Aside from regulatory and market pressures, the primary driver for consolidation is economics. In short, co-ops' rates are higher, on average, than rates for IOUs: 7.2 percent for commercial customers, 4.6 percent higher for industrial customers, and 3.4 percent for residential customers (*see Figure 2, "Average Utility Rates (2002)," p. 75*). In some places the disparity is dramatic. For example, co-ops are charging industrial customers 38 percent higher rates than IOUs, on average, in the 15 states where co-op rates are highest, relative to IOU rates.

Of course, in some states co-ops are providing lower rates, but on average, co-op power is more expensive. To what degree higher rates are attributable to low customer density is difficult to determine, but the bottom line is that co-op customers on average pay more for their power than IOU customers.

Williams and others argue that co-op rates would be lower if it weren't for the unnecessary expense that comes with balkanization. "Local control has a cost, and it's not cheap," Williams says. "Texas has about 75 co-ops. That means 75 headquarters offices, 75 sets of board directors, 75 general managers, 75 IT systems. … If co-ops would consolidate themselves into larger groups, many of those costs would be reduced."

Other analysts agree. "Generally, the utility industry is overly fragmented and would benefit from more consolidation across all areas," says George Bilicic, a managing director with Lazard in New York. "There's no reason that co-ops shouldn't be able to realize the scale benefits of being more diverse, having a larger asset base and eliminating overlapping overhead."

Co-ops remain balkanized, however, largely because of their dedication to local control. For decades this has served to limit consolidation among co-ops, but that might be about to change.

First, customer demographics are changing. Formerly rural service territories are becoming increasingly urbanized, and co-ops' customer/owners might be less concerned about local control than their rural predecessors might have been.

More broadly, the role of agriculture in today's society is diminished from what it was 70 years ago. In the mid-1930s, a much smaller United States had nearly 7 million family farms; today there are fewer than 2 million. Accordingly, rural interest in the locally focused cooperative structure might be diminishing.

Second, in today's market, IOUs are seeking growth opportunities that are consistent with the "back-to-basics" strategies that investors and rating agencies are demanding of them. In such an environment, balkanized co-ops are beginning to look like ripe fruit—especially those that are in fast-growth suburban markets, adjacent to IOU territories.

"These co-ops are especially attractive," Tirello says. "IOUs could acquire them for a fair price, and the transaction would be accretive to earnings upon completion."

The challenges, however, might prove to be substantial. Perhaps the biggest issue involves the cost-effectiveness of pursuing a complicated acquisition that yields a relatively small number of customers. "The biggest co-ops have less than 200,000 customers," says Lange of Lehman Brothers. "That wouldn't move the needle enough for most IOUs to consider an acquisition worthwhile, unless it was a very friendly transaction. You'd almost need to have the co-op show up on your doorstep and ask to be acquired. That's not happening."

Indeed, co-op acquisitions are almost certain to be hostile and contentious. But Tirello notes that such issues are not insurmountable; they just require an intelligent approach. "You have to approach it as though you are marketing a new product, or conducting a political campaign," Tirello says. "There are myriad things you can do to turn the tide in your favor, but you have to be prepared to spend some money up front." As examples he suggests conducting focus groups and placing advertising around the issue.

Williams adds that multiple adjacent co-ops could be acquired in the same effort, which would make such a campaign more cost-effective. He further notes that co-op customers will be receptive to a simple message that offers clear benefits. "Most co-op members don't know they own the co-op. When members realize they've been providing free capital to the co-op, they will begin to wonder where their money has gone," Williams says. "By acquiring co-ops, IOUs can give that money back to members—all at once, in cash—and still reduce rates."

Avalanche Warning

The world is changing around electric cooperatives, and in time they will be forced to adapt to this new environment.

"The historic *status quo* has served us well," Zimmer says. "The stability of rural co-ops and municipal utilities has been a shining light compared with the market capitalization and credit issues on the regulated side of the industry. But the verdict is still out. The electric power mission in the country is being redefined, and we may need to tweak our systems and make adjustments to be competitive for the future."

Consolidation, in one form or another, seems like an inevitable adjustment for the utility industry as a whole, and cooperatives seem unlikely to entirely escape this trend.

"I think the time is right for IOUs to acquire co-ops," Tirello says. "The first one might be difficult, but if one or two of them happen, it could become an avalanche."

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