




Washington Rural Electric Cooperative Association

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To: Citizen Commission for Performance Measurement of Tax Preferences

From: Kent Lopez, General Manager

RE: Commission Action Concerning Tax Treatment - 82.04.43394 RCW

The Washington Rural Electric Cooperative Association (WRECA) commends the Citizen Commission for Performance Measurement of Tax Preferences (Commission) on its decision to accept the Chair's recommendation to continue the B&O tax deduction for electric cooperatives ("Group D" of the Commission's recommendations, October 14, 2016), which is scheduled to expire July 1, 2017.

Background

More than 900 rural electric cooperatives serve over 42 million consumers in 48 states. In Washington, rural electric cooperatives serve over 280,000 member/consumers at approximately 149,000 locations. Washington's rural electric cooperatives provide service to approximately 25% of the land area of our State.

Rural electric utilities require steady and affordable access to capital for their continual investment in the rural utility infrastructure, which is required to provide essential electric service. However, they face unique challenges in accessing capital markets. They are small (the median cooperative in Washington serves about 8,000 member/consumers compared to 13,000 consumers served by the median co-op in the US and 400,000 for the median investor-owned utility). Nationally, few electric cooperatives are active in the capital markets (less than 30 are publicly rated) and few have a significant relationship with major banks.

In 1969, America's electric cooperatives created the National Rural Utilities Cooperative Finance Corporation (CFC) to help bridge them to the capital markets and provide ready access to capital. WRECA is a member of the CFC, as are 14 rural utility systems in Washington State. Nearly all of the rural electric cooperatives in the U.S. rely on the CFC to provide access to loans and a range of financial products and services, including the 14 electric cooperatives in Washington. As of May 31, 2016, rural electric cooperatives in Washington have approximately \$305 million in outstanding loans with CFC.

The CFC is 100% owned by and serves its membership, which consists primarily of nonprofit rural electric systems. To qualify as a member of the CFC, rural utilities must be eligible to borrow, or have borrowed from, the Rural Utilities Service (RUS), an agency within the United States Department of Agriculture. Eligible electric systems almost exclusively serve communities of 20,000 or fewer customers and are organized on a not-for-profit basis.. The CFC's sole objective is to offer its members cost-based financial products

and services consistent with sound financial management, not to maximize net income. As a result, the CFC's member/borrowers benefit by paying lower rates on their loans and those benefits are ultimately passed on to the rural ratepayer consumers served by the CFC's members.

The CFC is exempt from federal taxation under IRC section 501(c)(4). This federal tax exemption is recognized by all but two states: California and Hawaii. (In California and Hawaii, the CFC has only a few members and relatively minor lending activity in those states.)

Recognizing the unique purpose and status of the CFC, in 2013 the state enacted a tax deduction that is scheduled to expire on July 1, 2017.

Comments

We would like to address three comments from the JLARC Preliminary Report: 2016 Tax Preference Performance Reviews – Rural Electric Cooperative Finance Organization B&O Tax Deduction (Report).

First, in the "Public Policy Objective" statement, the Report states "the Legislature stated the public policy objective was to provide tax relief for customers of rural electric cooperatives by providing this incentive to finance organizations that lend to rural electric cooperatives."

However, the B&O tax on the interest paid by rural electric cooperatives is imposed on the CFC, not the rural electric cooperatives or their customers. As a not-for-profit, federally tax-exempt organization, the CFC's costs are borne by its members – the rural electric cooperatives. Therefore, the benefit realized by the CFC due to the B&O tax deduction would result in lower costs to the CFC for providing the capital needed by its members, the rural electric cooperatives.

There is no direct "tax relief" available to the customers of rural electric cooperatives because the tax isn't imposed on the customers. The tax deduction, however, results in less costs to the CFC for doing business and therefore, the not-for-profit, consumer-owned rural electric cooperatives that rely on the CFC for their capital needs. Congruently, any increase in costs to the CFC for doing business, such as the B&O tax assessment, ultimately will be borne by its rural electric system members.

Second, the Report reports that there was testimony which indicated that the average rural electric cooperative customer would save an average of \$1.73 per year over the next ten years due to the tax deduction passed by the legislature.

This was a hypothetical estimate and was derived by estimating the cost savings that the CFC would have realized had the tax deduction been available for FY 2012. The "per customer"

estimate was arrived at by dividing the number of customers served by rural electric cooperatives in Washington who were paying interest to the CFC in 2012 into the estimated savings to the CFC. However, since the average electric cooperative customer monthly bill is close to \$100, it is very difficult to document a reduction of \$0.14 per month in the customer's bill due to the tax deduction.

As a point of clarification, there is not an itemized charge on the invoices from the CFC to the rural electric cooperatives specifying the B&O tax that the CFC paid on the interest collected from a specific rural electric cooperative. Therefore, the rural electric cooperative also does not include an itemized charge on the bills that it sends to its customers specifying a B&O tax liability.

Finally, in the section Are Objectives Being Met?, the Report states that "there is no evidence that the preference is providing tax relief for customers of rural electric cooperatives."

We would agree with this statement because as noted above, there is no tax burden on the customers of rural electric cooperatives and therefore, "tax relief" is not possible. The tax burden is on the CFC, increasing the cost of business for the member-owned financing organization created and designed for the sole purpose of providing capital for rural electric cooperatives that find it difficult, or even impossible, to find adequate capital for supporting the mission of providing reliable and safe electric service to the rural areas of the state.

Conclusion

As noted above, the CFC is exempt from federal taxation under IRC section 501(c)(4). This federal tax exemption is recognized by 48 states. The fundamental question is why shouldn't Washington join 47 other states and continue to recognize the federal tax exempt status granted CFC by the federal government?

Tax exemption for not-for-profit entities such as the CFC is a significant factor in the entity's ability to deliver the services for which it was created. Therefore, by recognizing the CFC's unique purpose and continuing the tax preference in 82.04.43394 RCW, Washington continues to provide a valuable benefit to the rural electric cooperatives and the rural communities that they serve.