

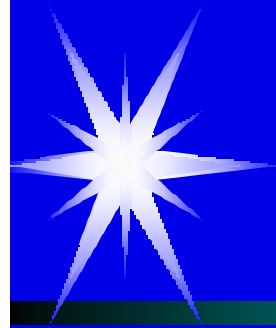


Chugach Electric Association, Inc.  
Anchorage, Alaska

**Capital Credits:  
Processes, Alternatives  
& Recommendations**

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# Capital Credits: Processes, Alternatives & Recommendations

Today's presentation will:

- ◆ Review capital credit processes.
- ◆ Review administrative effort and expense.
- ◆ Review factors to consider when evaluating retirement methods.
- ◆ Present alternative retirement methods.
- ◆ Provide management's recommendation.



# Capital Credits Processes

The basic capital credits processes include:

- ◆ Allocation
- ◆ Retirement
- ◆ Unclaimed Credits
- ◆ Estate Payments



# Margin Allocation

Each year's margins are "allocated" and credited to each member's capital account:

- ◆ On a "patronage" basis.
- ◆ In proportion to their contribution to Chugach's overall margin.



# Retirement

A “retirement” authorized by the Board:

- ◆ Allows payment of all or a portion of the capital credits allocated for a particular year.
- ◆ Is currently done on a “First In, First Out” (FIFO) basis.
- ◆ Total retirements to date approximately \$40 million.
- ◆ All credits through 1984 and some of 1985.



## Unclaimed Capital Credits

Capital credit payments that are not delivered to the intended recipient are “unclaimed”.

- ◆ A process is in place to keep these funds.
- ◆ The newspaper listing of names is an expensive but essential part of this process.
- ◆ The unclaimed balance is \$5.77 million.



# Estate Payments

Estate payments are made to the estates of deceased members.

- ◆ Payments are only for “natural” members.
- ◆ It is the only way capital credits are paid prior to normal retirement.
- ◆ They are paid at full face value.



# Administration

Capital credits administration is a significant effort.

- ◆ Uses the capital credits subsystem of the CIS.
- ◆ Includes Member Services, Information Services, Accounting and Member & Public Relations.
- ◆ Is expensive and greatly affected by the “churn” of the membership.



## Member Services Costs

Member Services costs in 2001:

- ◆ \$148,183 for labor (not including routine).
- ◆ \$53,059 for expenses such as materials, printing, inserting and postage.



## Factors to Consider

Factors to consider when evaluating alternate retirement methods include:

- ◆ Cost
- ◆ Fairness
- ◆ Public relations
- ◆ Funding constraints
- ◆ Effect on workload



# Administrative Costs

Cost is very important given limited resources.

- ◆ Each check or statement has a marginal cost.
- ◆ There is also a direct (though less quantifiable) cost of labor to do research and reissue checks.
- ◆ Management and staff effort and other overheads can be significantly affected by complex new methods or options.



# Fairness

Fairness is an issue as there are competing interests for limited funds.

- ◆ The FIFO method is generally viewed as fair because it is those members whose equity has been retained the longest that are getting their money back.



# Public Relations

Capital credits are a distribution of money and that should confer a public relations benefit.

- ◆ To a large extent they are viewed negatively.
- ◆ Members feel they have to wait too long and the amounts are often only a few dollars.
- ◆ A public relations benefit would accrue from a method that gets money back sooner or allows greater amounts to be paid.



# Funding

Funding is a very important consideration.

- ◆ If there are limited funds, increasing the number of members being paid leads to dilution of individual amounts.
- ◆ It is not good policy to increase funding and then to reduce it. Expectations should not be created that cannot be sustained.



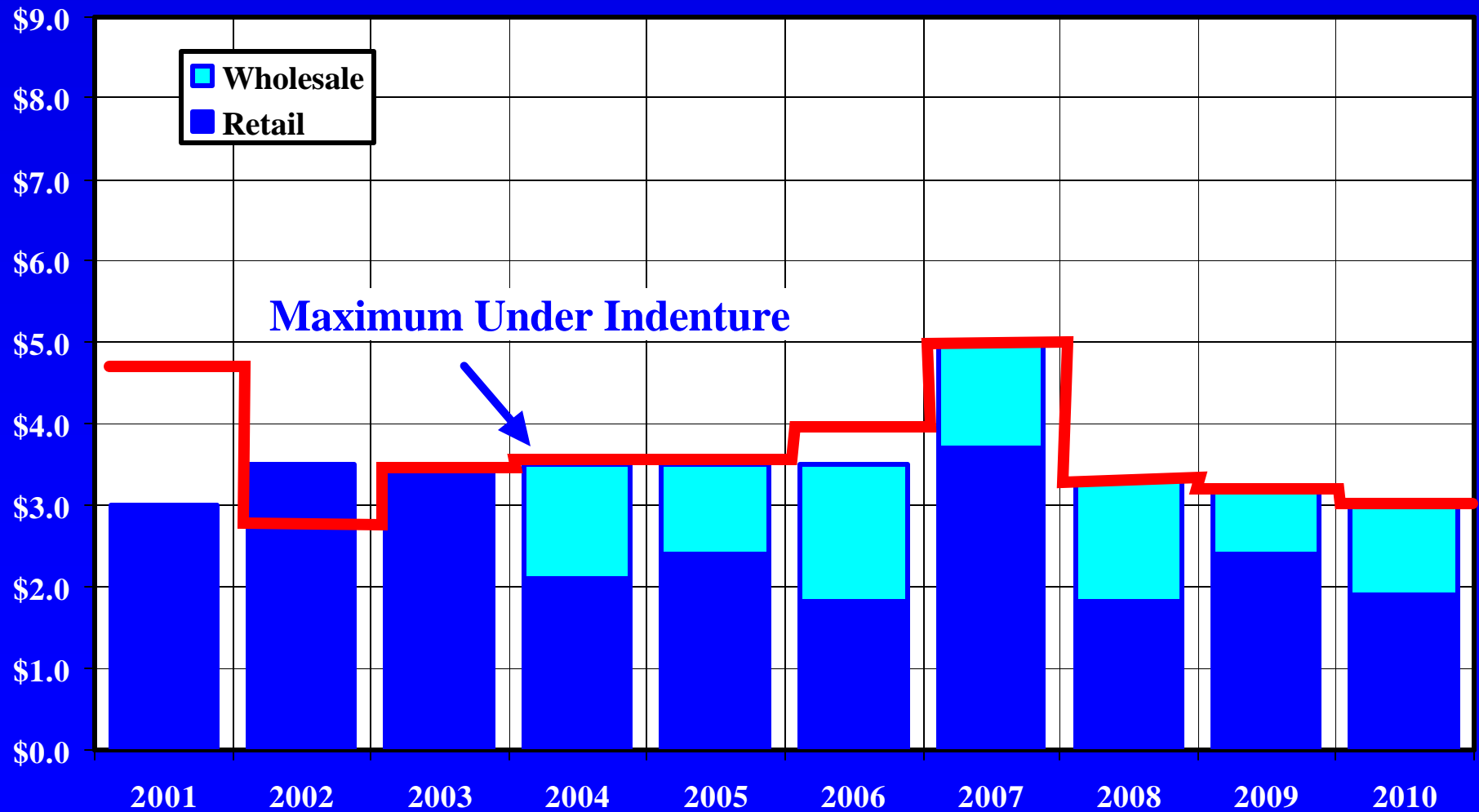
## Indenture Limitation

The new indenture limits on distribution are:

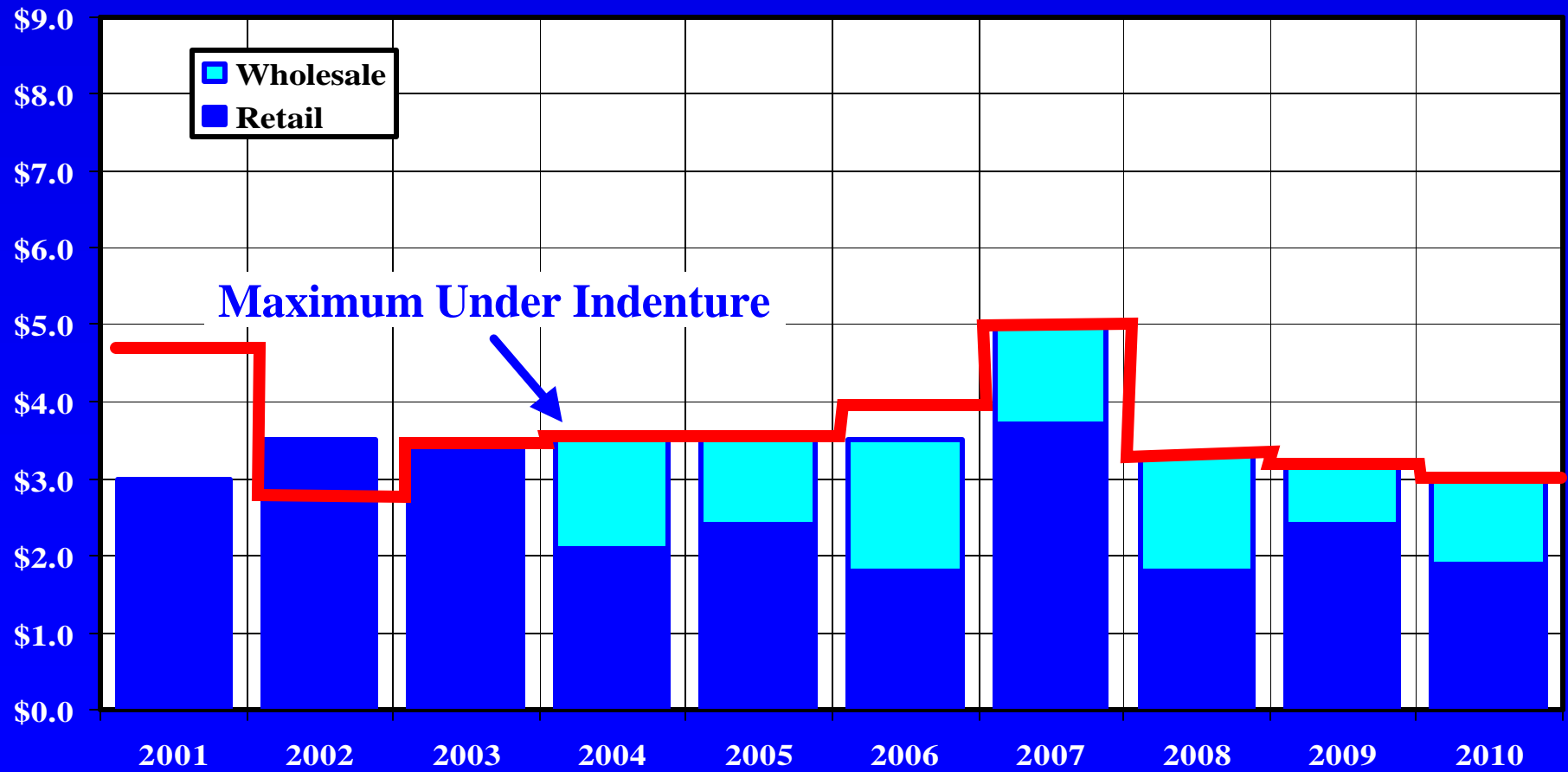
- ◆ No distribution if we are in any event of default.
- ◆ Limited to the lesser of 50% of prior year's margins or 5% of patronage capital. (This criteria will not likely be used based on forecasts.)
- ◆ The limit will not apply if, after a capital credit retirement, there is at least a 30% equity ratio.



# Indenture: 50% of Prior Fiscal Year's Margins



# Capital Credits Rotations and Equity Ratio



Equity Ratio 26% 25% 25% 26% 27% 28% 29% 30% 31% 32%



# Workload

Capital credits are labor intensive and the effect on workload is a consideration.

- ◆ Methods that increase the number of members being paid result in added work and expense.
- ◆ Likewise, a method that allows memberships to be closed removes the need for future checks and account maintenance.



## Alternative Methods

Some alternative retirement methods include:

- ◆ First In, First Out (FIFO)
- ◆ Last In, First Out (LIFO)
- ◆ FIFO/LIFO Combination
- ◆ Percentage
- ◆ Early (Discounted) Retirement



## "First In, First Out"

The FIFO method is Chugach's current method.

- ◆ It gives money back to members with the oldest capital credits.
- ◆ Only about 15,000 (25%) are still active.
- ◆ It does relatively little for current members.
- ◆ Volume is manageable and the average check for most members is in the \$15 to \$40 range.



## "Last In, First Out"

The LIFO method gives money back to the most recent members.

- ◆ Current members become more involved and aware of the benefits of a cooperative.
- ◆ Cost increases as about 50% more members are included.
- ◆ It will likely not be perceived as fair, as long-term members have up to 17 years of credits.



## "FIFO/LIFO Combination"

The FIFO/LIFO method pays both the longest-term and current members.

- ◆ It addresses the fairness issue by paying the most long-term as well as current members.
- ◆ Costs increase significantly as the number of members included more than doubles.
- ◆ Individual payment amounts are diluted unless funding also more than doubles.



# "Percentage"

The Percentage method gives money back to all members who have a capital credits balance.

- ◆ There are nearly 259,000 members with a capital credits balance.
- ◆ Additional administrative expense and dilution of the benefit are significant.



## “Early (Discounted) Retirement”

Early (Discounted) Retirement allows payments prior to normal retirements.

- ◆ It is a fair way for members to get their money sooner, and it is the member’s choice.
- ◆ Since payments are discounted at the cost of capital (11% or so per year), it makes financial sense.
- ◆ Cashing out former members reduces costs.



## “Early (Discounted) Retirement”

### Early (Discounted) Retirement (continued):

- ◆ Memberships paid in full now result in less funding required for future retirements.
- ◆ It creates “donated capital,” permanent equity that will grow, increasing the equity ratio.
- ◆ It can be extended to estate payments, cutting annual payments by nearly 50%.



## Primary Recommendation

To maximize the public relations benefit of capital credits, and with due consideration of cost, fairness, funding and workload, the Board should:

- ◆ Continue FIFO for normal retirements.
- ◆ Allow early retirement at a discounted rate.
- ◆ Discount estate payments.



## Supporting Recommendation No. 1

Limit discounted payments to former members.

- ◆ Capital credits provide security against bad debts. This security should be maintained until the member disconnects and no debt remains.
- ◆ The membership of a former member can be closed completely, removing the need for future effort and expense.



## Supporting Recommendation No. 2

Limit the total annual payout to \$500,000.

- ◆ The membership expects a retirement each year and funds must be available for normal retirements.
- ◆ This level of funding will allow the retirement of about \$1 million of capital credits.



## Supporting Recommendation No. 3

Only publicize this option via normal mailings, and specifically target former members.

- ◆ Place specific messages on statements and checks going to members who are inactive.
- ◆ These existing means limit incremental cost.
- ◆ Limited publicity is essential if limited funds are available.



## Remaining Issue

Ensure compliance with IRS regulations to protect tax exempt status.



# Capital Credits: Processes, Alternatives & Recommendations

**QUESTIONS ???**