Memorandum from the Office of the Inspector General

May 13, 2009

Kimberly S. Greene, WT 7B-K

FINAL REPORT – INSPECTION 2008-12007 – DISTRIBUTOR REVIEW OF MONROE COUNTY ELECTRIC POWER ASSOCIATION

Attached is the subject final report for your review and action. Your written comments, which addressed your management decision and actions planned or taken, have been included in the report. Please notify us when final action is complete.

Information contained in this report may be subject to public disclosure. Please advise us of any sensitive information in this report that you recommend be withheld.

If you have any questions, please contact Richard C. Underwood, Project Manager, at (423) 785-4824 or Gregory C. Jaynes, Deputy Assistant Inspector General, Inspections, at (423) 785-4810. We appreciate the courtesy and cooperation received from your staff during the audit.

Gregory C. Jaynes

(for) Robert E. Martin
Assistant Inspector General
(Audits and Inspections)
ET 3C-K

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OIG File No. 2008-12007

Tennessee Valley Authority
Office of the Inspector General

Inspection Report

DISTRIBUTOR REVIEW OF MONROE COUNTY ELECTRIC POWER ASSOCIATION

Project Manager
Rick Underwood

Inspection 2008-12007
May 13, 2009

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APPENDICES

TVA Office of the Inspector General

Why the OIG Did This Review

As part of the annual inspection plan, the OIG performed a review of Monroe County Electric Power Association (Monroe) which is a distributor for TVA power based in Amory, Mississippi. Annual revenues were approximately $18.4 million in fiscal year 2008. TVA relies on distributors to self report customer usage and subsequently the amount owed to TVA (Schedule 1). Customers are generally classified as residential, commercial, and manufacturing. Within these classifications are various rate classes based on the customer type and usage.

The objective of the review was to determine compliance with key provisions of the power contract between TVA and Monroe including (1) proper reporting of electricity sales by customer class to facilitate proper revenue recognition and billing by TVA; (2) nondiscrimination in providing electricity to members of the same rate class; and (3) use of revenues, including any surplus, for approved purposes such as operating expenses, debt service, tax equivalent payments, and reasonable reserves for renewals, replacements, and contingencies.

What the OIG Recommends

We recommend the Chief Financial Officer (CFO) take action to ensure Monroe complies with contract provisions regarding accounting practices and formal customer contracts. In addition, the CFO should (1) provide additional guidance on proper use of funds, (2) review its calculation of the cash ratio for distributors with prepayment power accounts, (3) develop criteria to be used in determining whether a distributor's cash reserves are excessive, and (4) provide guidance on the frequency of meter testing.

TVA and Monroe management generally agreed with and are taking actions to address the recommendations. See Appendices for complete responses.

For more information, contact Richard Underwood, Project Manager, at (423) 785-4824 or Gregory Jaynes, Deputy Assistant Inspector General, Inspections, at (423) 785-4810.

May 2009

Inspection 2008-12007 Monroe County Electric Power Association

What the OIG Found

Our review of Monroe found no material issues related to (1) the proper reporting of electric sales and (2) nondiscrimination in providing electricity to members of the same rate class. However, we found improvements were needed in the following areas:

- Contract compliance issues regarding Monroe's accounting practices and implementation of customer contracts. Monroe's contract with TVA requires (1) the distributor's accounting practices to follow Federal Energy Regulatory Commission (FERC) guidelines and (2) Monroe to have contracts with all customers whose demand is greater than 50 kW. Our review found Monroe's accounting for prepaid expenses did not conform to FERC guidelines and required contracts for Monroe customers with demand greater than 50 kW were not in place for all customers.

- Monroe's internal controls could be improved by maintaining an inventory of installed meters for comparison to customer billings to identify discrepancies. Subsequent to our site visit, Monroe entered into an agreement with Central Service Association for implementation of a meter management system. This action addressed our concerns.

In addition, we found Monroe had more than enough cash on hand to fund planned capital expenditures and provide a cash reserve. While TVA has established guidelines to determine if a distributor has adequate cash reserves (cash ratio of 5 to 8 percent), TVA has not established guidelines to determine if a distributor's cash reserves are excessive.

- As of June 30, 2008, Monroe reported about $2.9 million in cash and $4.9 million in the TVA Power Invoice Prepayment Program and planned capital expenditures of about $5 million which left a cash reserve of about $2.7 million.

Finally, we also identified opportunities to enhance TVA oversight of the distributors. Specifically, TVA (1) does not include cash used to prepay for TVA power in the calculation of the cash ratio for rate review purposes and has not defined criteria for determining when a distributor's cash reserves are excessive, (2) has not provided definitive guidance for distributors on what constitutes prudent expenditures, and (3) has not adequately defined how often meters should be tested by the distributors.

BACKGROUND

The Monroe County Electric Power Association (Monroe) is a distributor for Tennessee Valley Authority (TVA) power based in Amory, Mississippi, with revenues from electric sales of approximately $18.4 million in fiscal year (FY) 2008. TVA relies on distributors to report customer usage and subsequently the amount owed to TVA (Schedule 1). Customers are generally classified as residential, commercial, and manufacturing. Within these classifications are various rate classes based on the customer type and usage. Table 1 shows the customer mix for Monroe as of June 2008.

Monroe's Customer Mix as of June 2008

Customer Classification	Number of Customers	Revenue	Kilowatt Hours Sold
Residential	8,869	$13,414,761	162,282,513
General Power – 50 kW & under (Commercial)	2,831	2,126,619	19,868,222
General Power – Over 50 kW (Commercial or Manufacturing)	93	2,225,199	24,260,495
Street and Athletic	44	36,594	467,182
Outdoor Lighting		589,713	5,522,028
Total	**11,837**	**$18,392,886**	**212,400,440**

Table 1

The distributors are required to establish control processes over customer setup, rate application, and measurement of usage to ensure accurate and complete reporting to TVA. Monroe, like many other distributors, outsources its billing and invoice processing to a third-party processor, Central Service Association (CSA). Monroe uses CSA systems to establish and set up new customers, input customer meter information, perform the monthly billing process, and execute customer account maintenance. Additionally, CSA provides Monroe with the management reporting (e.g., exception reports) designed to ensure the accuracy and completeness of the customer invoice and the purchased power invoice (Schedule 1) to TVA. All other accounting and finance responsibilities are done by Monroe which has a Board of Directors providing oversight and a general manager and treasurer managing the daily activities. Monroe does not have any nonelectric business interests.

OBJECTIVE, SCOPE, AND METHODOLOGY

This inspection was initiated as a part of our annual workplan. The objective was to determine compliance with key provisions of the power contract between TVA and Monroe including:

- Proper reporting of electricity sales by customer class to facilitate proper revenue recognition and billing by TVA.

- Nondiscrimination in providing electricity to members of the same rate class.
- Use of revenues, including any surplus, for approved purposes such as:
  - Operating expenses;
  - Debt service;
  - Tax equivalent payments; and
  - Reasonable reserves for renewals, replacements, and contingencies.

To achieve our objective, we:

- Documented and assessed the controls over new customer account setup and master file maintenance.
- Documented and tested the procedures and controls in place to ensure proper sales cutoff and the reconciliation of sales to the general ledger.
- Documented and tested the procedures and controls in place to ensure complete and accurate invoicing of payments to TVA.
- Determined through inquiry and review of documentation whether Monroe had any nonelectric, system-related business interests supported by electric system funds.
- Reviewed disbursements to determine if electric system funds were used for any items not allowed under the TVA power contract.
- Reviewed cash and cash equivalents in relation to planned capital expenditures and other business uses of cash.

The scope of the review was for the period July 2006 through June 2008. Fieldwork was conducted in September and October 2008. This review was conducted in accordance with the "PCIE Quality Standards for Inspections."

FINDINGS

Our review of Monroe found no material issues related to (1) the proper reporting of electric sales and (2) nondiscrimination in providing electricity to members of the same rate class. However, we found improvements were needed in the following areas: (1) contract compliance issues regarding Monroe's accounting practices and implementation of customer contracts and (2) Monroe's internal controls surrounding the customer setup process.

In addition, we found Monroe had more than enough cash on hand to fund planned capital expenditures and provide a cash reserve. While TVA has established guidelines to determine if a distributor has adequate cash reserves (cash ratio of 5 to 8 percent), TVA has not established guidelines to determine if a distributor's cash reserves are excessive. Finally, as we explain herein, there are significant opportunities to enhance TVA oversight of the distributors.

CONTRACT COMPLIANCE ISSUES

Our review noted two areas where Monroe was not meeting the requirements of the power contract with TVA. Specifically, we found (1) current accounting practices resulted in a prepaid expense recorded as cash, and (2) contracts were not in place for all customers whose power demand exceeds 50 kW in a month. Below is further discussion on these items.

Accounting Practices

We noted two instances in which Monroe's accounting records did not conform to Federal Energy Regulatory Commission (FERC) guidance. Under the contract, the distributor is required to keep the books of the electric system according to the Federal Power Commission Uniform System of Accounts (USofA). The Federal Power Commission was replaced by FERC in 1977 under the Department of Energy Organization Act. The FERC USofA requires the utility keep its accounts on the accrual basis. Specifically, we found revenue was not recognized in the month in which it was earned, and a prepayment for power is recorded as a cash-temporary investment instead of a prepaid expense.

Revenue

According to the FERC USofA, utilities' accounting records should include all known transactions of appreciable amount which affect the accounts. If bills for revenue earned have not been sent out during the accounting period, the utility is to estimate amounts due and make appropriate adjustments when the bills are sent.

Monroe recognizes revenue in the month it is billed rather than earned. As a result, the current month will contain revenue that should have been recognized (when service was provided) in a previous period. While Monroe does not have a process to accrue revenue earned but not billed for a given month and then a process to reverse the entry in the following period, their external auditor does make annual adjustments to recognize any material amounts of unbilled revenue. As a result, we make no recommendation.

Prepayment

Monroe's accounting records show the TVA Power Invoice Prepayment account as a cash-temporary investment account when it should be recorded as a prepaid expense. Under TVA's Power Invoice Prepayment Program, a distributor could prepay its current or future amounts due for power invoice(s). In return, TVA provides the distributor with an early payment credit which will accrue on the distributor's account daily. The interest rate used in calculating the early payment credit to be applied to the account changes monthly. According to the FERC USofA, when payments are made in advance, the amount applicable to future periods should be charged to an account titled Prepayments and spread over the periods to which the amounts are applicable by credits to the

Prepayments account and charges to the accounts appropriate for the expenditure.

Customer Contracts
Under Monroe's contract with TVA, all customers that exceed 50 kW monthly are required to sign a formal contract. According to Monroe management, this requirement was not enforced by TVA prior to its request for the distributor to provide a Statement on Auditing Standards (SAS) 70 Type II Report assessing the design and effectiveness of the distributors' internal controls over end-use billing revenue. Subsequently, Monroe management requested their customers with demand greater than 50 kW to complete a contract; however, Monroe did not receive a signed copy back from all customers.

DISTRIBUTOR INTERNAL CONTROL ISSUE

We noted Monroe's internal controls could be strengthened during the customer setup process to improve metering. Specifically, the process could be enhanced to ensure each meter (and the type of meter for nonresidential customers) installed is associated with an active customer in the system. According to Monroe management, the meter inventory is not tracked when it leaves the warehouse. In addition, a monitoring report could be created to periodically compare active customers to a meter which would ensure an active customer is appropriately metered and billed.

Subsequent to our site visit, Monroe entered into an agreement with CSA for implementation of a meter management system. This system provides computerized system management of all meters and allows Monroe to identify all meters they own as Active, Vacant, New or Inactive. The new system also has reporting capabilities which allow Monroe to monitor and manage the meters. Monroe's subsequent actions address the control issues identified during our site visit.

USE OF ELECTRIC SYSTEM REVENUES

Under the TVA power contract, approved uses of revenues from electric system operations, including any surplus, are (1) operating expenses; (2) debt service; (3) tax equivalent payments; and (4) reasonable reserves for renewals, replacements, and contingencies. While TVA has established guidelines to determine if a distributor has adequate cash reserves (cash ratio[1] of 5 to 8 percent), TVA has not established guidelines to determine if a distributor's cash reserves are excessive.

[1] TVA reviews the cash ratios of distributors as part of its regulatory rate review function. Cash ratio is calculated as follows: $\frac{\text{Cash + Cash equivalents}}{\text{Total Variable Expenses (Operations and Maintenance + Purchased Power)}}$

Our review of Monroe's financial status and planned capital projects found Monroe had more than enough cash on hand to fund planned capital expenditures and provide a cash reserve. As of June 30, 2008, Monroe had about $2.9 million in its actual cash accounts and approximately $4.9 million in its TVA Power Invoice Prepayment account which totaled about $7.8 million. Table 2 shows information about plans for major capital expenditures obtained from Monroe's general manager and our review of Monroe's Board of Director's meeting minutes.

Monroe's Planned Capital Expenditures

Capital Expenditure Plans	Project Cost	Planned Completion
Automatic Reading Meters	$1,050,000[2]	CY 2008
New Substation at Caledonia (Caldwell Road Substation)	$2,500,000	CY 2010
Modify the Existing Caledonia Substation to Serve Caledonia Energy Partners	$1,000,000	Unknown
U S Highway 25 Four Lane Project	$500,000	Unknown
Total Cost	**$5,050,000**	

Table 2

When compared to Monroe's capital expenditure plans for the foreseeable future, the balance in the TVA Power Invoice Prepayment account and Monroe's cash accounts was enough to pay for these items and leave about $2.7 million as a reserve, as shown in Table 3. Table 3 also shows Monroe's cash ratio percentage was about 47.4 percent before accounting for planned capital expenditures and 16.7 percent after accounting for them.

Monroe's Cash Accounts Compared to Planned Capital Expenditures

	Cash and Cash Equivalents Plus Prepayment Account	Planned Capital Expenditures	Reserve After Planned Capital Expenditures
	$7,790,982	$5,050,000	$2,740,982
FY 2008 Cash Ratio Percentage	47.4%		16.7%

Table 3

Discussions with Monroe's management indicated the operating philosophy of the Monroe board and management was to use a conservative, debt-averse approach. According to TVA records, over the past five years, Monroe has been approved for rate increases of 1 percent in 2005 and 0.5 percent in 2007. Table 4 shows the rate increases received by Monroe and the cash position and cash ratio at June 30 prior to the effective date of the rate increase.

2 As of June 30, 2008, $450,000 had already been expended for the $1,500,000 total cost of the changeover to automatic reading meters.

Monroe's Rate Increases, Cash Position, and Cash Ratio

Cash on Hand Equivalent to an 8% Cash Ratio	Cash and Cash Equivalents[3] and Cash Ratio		Rate Increase		
	With Prepay Account	Without Prepay Account	Additional Revenue	Percent	Effective Date
$1,155,124	$7,511,268 (CR = 52%)	$4,399,908 (CR = 30.5%)	$150,000	1.0%	10/1/2005
$1,293,671	$7,746,958 (CR = 47.9%)	$3,060,216 (CR = 18.9%)	$83,616	0.5%	4/1/2007

Table 4

Coupled with this debt-averse philosophy, distributors consider cash reserves as a hedge against the risks of unforeseen costs from an aging infrastructure (e.g., equipment failure), potential loss of revenue from the economic impact on commercial and industrial customers, and unpredictable weather. Examples of weather events[4] TVA distributors have incurred include damage from (1) the recent January 27, 2009, ice storm in Kentucky and Tennessee where about 130,000 of TVA distributor consumers lost their electricity and (2) tornados and the impact of tropical storms, such as the 2005 damage to Mississippi systems resulting from hurricane Katrina.

TVA OVERSIGHT OPPORTUNITIES

We found opportunities to enhance TVA's oversight of the distributors. Specifically, we noted TVA (1) does not include cash used to prepay for TVA power in the calculation of the cash ratio for rate review purposes, and has not defined criteria for determining when a distributor's cash reserves are excessive, (2) has not provided definitive guidance for distributors on what constitutes prudent expenditures, and (3) has not adequately defined how often meters should be tested by the distributors.

Distributor Cash Position

We noted two issues that TVA needs to address related to the assessment of a distributor's cash position. Specifically, TVA (1) does not include cash used to prepay for TVA power in the calculation of the cash ratio for rate review purposes and (2) has not defined criteria for determining when a distributor's cash reserves are excessive.

Use of Cash Prepaid to TVA for Power in the Cash Ratio Calculation

Monroe's cash ratio was about 13.8 percent and 17.6 percent in FYs 2007 and 2008, respectively. These calculations do not include the balance in the

[3] The cash and cash equivalents and cash ratio were computed based on information from Monroe's annual report as of June 30 prior to the effective date of the rate increase.

[4] After a severe weather event, utilities launch massive and costly round-the-clock restoration efforts. In addition to costs for miles of new wire, new poles, new transformers, and their own crews, utilities often have to pick up the bill for other utility crews providing assistance in the restoration effort.

previously discussed TVA Power Invoice Prepayment account. From an accounting perspective, the Power Invoice Prepayment account is considered restricted because, once deposited, it cannot be withdrawn. By definition, TVA does not include restricted cash in the cash ratio calculation. However, although technically restricted, distributors can only use these funds to pay monthly power bills which provide the same benefit of nonrestricted cash resources.

Prepayment deposits could allow distributors to reduce their overall unrestricted cash balances while receiving the benefit of a market-based interest return from TVA. Without including the prepayments or a portion of the prepayments, a distributor's cash position may appear lower than it actually is which could impact the financial analyses of the distributor during the rate review process. Table 5 shows the effect on the cash ratio of including all or a portion of the prepayment account in the cash ratio percentage calculation.

Alternative Cash Ratio Percentage Calculations for Monroe

	FY 2007 Cash Ratio	FY 2008 Cash Ratio
Cash only	13.8%	17.6%
Cash plus all of the prepayment account	40.7%	47.4%
Cash plus all of the prepayment account less one month's average power cost	33.7%	40.0%

Table 5

Criteria for Evaluating When a Distributor's Cash Is Excessive
While TVA has established guidelines to determine if a distributor has adequate cash reserves (cash ratio of 5 to 8 percent), TVA has not established guidelines to determine if a distributor's cash reserves are excessive. TVA uses the cash ratio as one of the factors in determining if a rate increase is warranted for a distributor. However, the lack of defined criteria identifying when a distributor may have more than adequate cash on hand could negatively impact TVA's analysis regarding whether (1) a distributor's rates should be lower or (2) an additional rate review may be warranted.

No Policies Defining Appropriate Expenditures
We noted TVA could improve the controls over the use of electric system funds by providing more definitive guidance to the distributors. While reviewing the proper use of electric system revenue, we noted there were no definitive policies on permitted expenditures (charity, scholarships, etc.) or investments/account establishment. TVA has allowed distributor management and distributor Board's discretion in the decision-making process for determining what qualifies as operational expenditures. Additional guidance in this area by TVA would decrease the likelihood of misinterpretation of what constitutes a reasonable use of electric funds. In discussions with the TVA Vice President, Strategy, Pricing, and Contracts, actions to address recommendations in a previous review of TVA's role as a regulator (Inspection 2005-522I) include the development of distributor guidance pertaining to the use of electric system funds.

Meter Accuracy
TVA could provide more definitive guidance regarding the frequency of meter testing for distributors. Under the power contract with Monroe, Part 21 (Meter Tests) of the Schedule of Rules and Regulations states: "Distributor will, at its own expense make periodical tests and inspections of its meters in order to maintain a high standard of accuracy." Additional guidance in this area could lead to (1) timely identification of inaccurate meters, (2) timely correction of errors, and (3) a uniform testing frequency of meters across distributors. This could result in (1) additional revenue collected by the distributor and (2) reduced distribution loss payments[5] to TVA. The reduction of these payments and the collection of additional revenues by the distributor, if significant, could reduce the need for future rate increases by distributors. In addition, the distributor would be reporting more accurate usage and demand information to TVA (both from a volume and billing rate classification standpoint) for revenue collection and future rate setting purposes. In meter testing conducted by Monroe in 2007, 2 of the 15 meters tested (about 13 percent) were found to have problems which could impact the accuracy of the meter.

RECOMMENDATIONS

We recommend the Chief Financial Officer (CFO) work with Monroe to improve compliance with the contract. Specifically, Monroe should:

1. Change accounting practices to be in accordance with FERC to accurately record the prepayment of power as a prepaid expense.

   Monroe's Response – Monroe management stated to their knowledge they were following TVA's recommendation regarding the accounting procedure for the Power Invoice Prepayment Program. They will discuss the accounting procedure with TVA and will be willing to make any necessary changes in the future as to how they account for the Power Invoice Prepayment Program. The report was clarified and the recommendation modified to reflect additional information pertaining to the recognition of unbilled revenue. See Appendix A for Monroe's complete response.

[5] Distribution loss payments are calculated using a distribution loss factor (DLF) which is the difference between the kWhs used (as reported by the distributor on Schedule 1) and the kWhs delivered to the distributor by TVA. Each month, the 12-month rolling average of the DLF is multiplied by the "Total Demand and Energy Charges" for the month and added to the amount owed to TVA by the distributor on Schedule 1. The "Total Demand and Energy Charges" includes charges for both kWh and kW demand. There is not a mechanism to perform the same calculation for kW demand as for kWh. As a result, TVA's practice is to also apply the DLF which is based on kWh to the kW demand charges. In this review, we did not try to determine if there is a more accurate method.

On an annual basis, TVA and the distributor perform a "Distribution Loss Trueup." This trueup uses the preceding 12-month average of the DLF multiplied by the total of the "Total Demand and Energy Charges" for the 12-month period and then subtracts the monthly estimated Distribution Loss Charges paid to TVA to determine if the distributor owes additional money to TVA or if a credit is due to the distributor.

TVA Management's Comments – The CFO agreed with our recommendation and stated TVA will work with each distributor to ensure energy prepayments are classified as a prepaid expense in the distributor's FY 2009 annual financial statements. Target completion date is December 2009. See Appendix B for TVA's complete response.

Auditor's Response – The Office of the Inspector General (OIG) concurs with the planned actions.

2. Review management reports listing customers that are above 50 kW hours without a contract and work with these customers to obtain signed contracts.

Monroe's Response – Monroe agreed the contract with TVA required contracts for customers with demand over 50 kW and without a contract. Monroe stated that this contract requirement had not been enforced by TVA prior to the SAS 70 Type II audit for June 30, 2006. At that point, Monroe began obtaining contracts and currently have obtained contracts for approximately 82 percent of the customers that are required to have them. They also have restarted the process to obtain contracts from the remaining 18 percent of customers. See Appendix A for Monroe's complete response.

TVA Management's Comments – The CFO agreed the Schedule of Rates and Charges requires distributors to obtain contracts with all customers whose actual or contract demand exceeds 50 kW. However, the CFO did not agree with our recommendation that Monroe should review management reports listing customers that are above 50 kW hours without a contract and work with these customers to obtain signed contracts. Rather, TVA management finds that the contract size threshold of 50 kW was established in 1963, and the relative customer size in 2009 versus 1963 is very different. Likewise, requiring contracts with small commercial customers is a time-consuming and difficult task which may provide little benefit for distributors or the TVA system. TVA management will recommend to the Board that a new and higher threshold be established as part of the rate change process with the distributors. When the rate change is put into effect, all retail customers above the new threshold will be expected to have executed contracts. Target completion date will coincide with the rate change efforts that are currently under way with the distributors and is expected to be in place by October 2010. See Appendix B for TVA's complete response.

Auditor's Response – The OIG concurs with the planned actions.

The CFO, in collaboration with the TVA Board of Directors where necessary, should:

3. Develop a comprehensive guide on permitted expenditures under the use of electric system revenues provision and expense accrual for distributor management to use going forward.

TVA Management's Comments – The CFO agreed it is appropriate to look at permitted expenditures in the context of the use of revenues provision in Section 6 of the wholesale power contract with the distributors. TVA management is exploring with the TVA Board the extent to which a comprehensive guideline is feasible and whether the TVA Board desires to adopt a policy that would employ such a guideline. Target completion date is December 2010. See Appendix B for TVA's complete response.

Auditor's Response – The OIG concurs with the planned actions.

4. Review the definition of cash ratio and determine if the ratio calculation should include some or all amounts in the TVA Power Invoice Prepayment account.

   TVA Management's Comments – TVA management agreed to review the definition of the cash ratio and determine if any adjustments are appropriate. Target completion date is December 2009. See Appendix B for TVA's complete response.

   Auditor's Response – The OIG concurs with the planned actions.

5. Develop criteria to be used in determining whether a distributor's cash reserves are excessive and incorporate the criteria into the rate setting process.

   TVA Management's Comments – Management will make recommendations to the TVA Board that additional financial metrics should be employed for purposes of administering the resale rate provisions in Section 5 of the wholesale power contracts. The need to consider cash reserves will be included in TVA management's recommendations to the Board. A change in the current guidelines to include these additional financial metrics requires Board action. Target completion date is December 2010. See Appendix B for TVA's complete response.

   Auditor's Response – The OIG concurs with the planned actions.

6. Review the requirements in the power contract and develop more definitive guidance on how often meters should be tested.

   TVA Management's Comments – TVA management expects to soon begin formal implementation of a rate change that will replace end-use wholesale rates with a structure that will be primarily based on wholesale meter data. Target completion date will coincide with the rate change efforts that are currently under way with the distributors and is expected to be in place in October 2010. The power contracts do not address the frequency of meter testing. TVA views this as a utility standards issue for the distributor. However, TVA will work with the distributor group TVPPA to develop recommendations on common meter testing criteria. Target completion date for common meter testing criteria is October 2010. See Appendix B for TVA's complete response.

Auditor's Response – The OIG concurs with the planned actions.

Other Comments From Monroe – Monroe provided comments regarding the use of electric revenues. Specifically, Monroe does not believe that a cash reserve of 5 to 8 percent is adequate enough for the many unforeseen costs that face an electric utility. Monroe noted the unpredictable weather and increases in fuel and material costs experienced during the last few years. Monroe stated that it prides itself on having some of the lowest rates in the Valley while at the same time maintaining adequate cash reserves that will cover any unforeseen event without any additional borrowing or cost to its members. See Appendix A for Monroe's complete response.

Recommendations 3 and 5 also apply to another separately issued distributor report.

MONROE COUNTY
Electric Power Association
The First REA Co-op in the United States

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April 30, 2009

Mr. Robert E. Martin, Assistant Inspector General
Office of the Inspector General
400 West Summit Hill Drive
Knoxville, Tennessee 37902

Dear Mr. Martin:

Monroe County Electric Power Association (MCEPA) has reviewed the findings of the draft inspection which determined if we were in compliance with key provisions of the existing TVA Power Contract. We respect the findings of your office and will work with TVA to make any necessary changes in order to meet contract compliance.

Enclosed for your consideration is MCEPA's response for each finding. If you have any questions or if I can provide any further information, please call me at (662) 256-2962.

Sincerely,

Barry Rowland

Barry Rowland, P.E.
General Manager

Enclosure

Cc: Ms. Kimberly S. Greene
Tennessee Valley Authority

FINDINGS

I. CONTRACT COMPLIANCE ISSUES

A. Accounting Practices

1. Revenue

Finding - According to the FERC USofA, utilities' accounting records should include all known transactions of appreciable amount which affect the accounts. If bills for revenue earned have not been sent out during the accounting period, the utility is to estimate amounts due and make appropriate adjustments when the bills are sent.

Monroe recognizes revenue in the month it is billed rather than earned. As a result, the current month will contain revenue that should have been recognized (when service was provided) in a previous period. Monroe does not have a process to accrue revenue earned but not billed for a given month and then a process to reverse the entry in the following period. While not required by the contract, recognizing revenue in the month earned rather than billed would also be in accordance with Generally Accepted Accounting Principles.

Monroe County EPA's response - In the past it has been Monroe County Electric Power Association's practice, with instruction from TVA, to not account for the unbilled revenue or the unbilled purchase power. However, our independent auditor does account for the unbilled revenue and unbilled purchase power in our fiscal year end audit report. We will be in discussion with TVA and our independent auditor to make any necessary changes.

2. Prepayment

Finding - Monroe's accounting records show the TVA Power Invoice Prepayment account as a cash-temporary investment account when it should be recorded as a prepaid expense. Under TVA's Power Invoice Prepayment Program, a distributor could prepay its current or future amounts due for power invoice(s). In return, TVA provides the distributor with an early payment credit which will accrue on the distributor's account daily. The interest rate used in calculating the early payment credit to be applied to the account changes monthly. According to the FERC USoA, when payments are made in advance, the amount applicable to future periods should be charged to an account titled Prepayments and spread over the periods to which the amounts are applicable by credits to the Prepayments account and charges to the accounts appropriate for the expenditure.

Monroe County EPA's response - To our knowledge we are following TVA's past recommendation regarding the accounting procedure for the Power Invoice

Prepayment Program. We will be discussing this accounting procedure with TVA and will be willing to make any necessary changes in the future as to how we account for the Power Invoice Prepayment Program.

B. Customer Contracts

Finding - Under Monroe's contract with TVA, all customers that exceed 50 kW monthly are required to sign a formal contract. According to Monroe management, this requirement was not enforced by TVA prior to its request for the distributor to provide a Statement on Auditing Standards (SAS) 70 Type II Report assessing the design and effectiveness of the distributors' internal controls over end-use billing revenue. Subsequently, Monroe management requested their customers with demand greater than 50 kW to complete a contract; however, Monroe did not receive a signed copy back from all customers.

Monroe County EPA's response – Although it is in the contract with TVA for Monroe County Electric Power Association to have a contract with customers that exceeded 50kW, it was not strictly enforced by TVA prior to having to have a SAS 70 Type II audit for year end June 30, 2006. At the time of the SAS 70 audit Monroe County Electric Power Association only had contracts on 12% of the customers that exceeded 50kW. After having the SAS 70 audit we began the process of gathering contracts for the remaining customers that exceeded 50kW. Currently we have contracts on approximately 82% of the customers that exceed 50kW and we have again begun the process to try and get signed contracts from the remaining 18%.

II. DISTRIBUTOR INTERNAL CONTROL ISSUE

Finding – We noted Monroe's internal controls could be strengthened during the customer setup process to improve metering. Specifically, the process could be enhanced to ensure each meter (and the type of meter for nonresidential customers) installed is associated with an active customer in the system. According to Monroe management, the meter inventory is not tracked when it leaves the warehouse. In addition, a monitoring report could be created to periodically compare active customers to a meter which would ensure an active customer is appropriately metered and billed.

Subsequent to our site visit, Monroe entered into an agreement with CSA for implementation of a meter management system. This system provides computerized system management of all meters and allows Monroe to identify all meters they own as Active, Vacant, New or Inactive. The new system also has reporting capabilities which allow Monroe to monitor and manage the meters. Monroe's subsequent actions address the control issues identified during our site visit.

Monroe County EPA's response – Finding addressed with the implementation of CSA's meter management system.

III. USE OF ELECTRIC SYSTEM REVENUES

Finding - Under the TVA power contract, approved uses of revenues from electric system operations, including any surplus, are (1) operating expenses; (2) debt service; (3) tax equivalent payments; and (4) reasonable reserves for renewals, replacements, and contingencies. While TVA has established guidelines to determine if a distributor has adequate cash reserves (cash ratio of 5 to 8 percent), TVA has not established guidelines to determine if a distributor's cash reserves are excessive.

Our review of Monroe's financial status and planned capital projects found Monroe had more than enough cash on hand to fund planned capital expenditures and provide a cash reserve. As of June 30, 2008, Monroe had about $2.9 million in its actual cash accounts and approximately $4.9 million in its TVA Power Invoice Prepayment account which totaled about $7.8 million.

When compared to Monroe's capital expenditure plans ($5,050,000) for the foreseeable future, the balance in the TVA Power Invoice Prepayment account and Monroe's cash accounts was enough to pay for these items and leave about $2.7 million as a reserve. Monroe's cash ratio percentage was about 47.4 percent before accounting for planned capital expenditures and 16.7 percent after accounting for them.

Discussions with Monroe's management indicated the operating philosophy of the Monroe board and management was to use a conservative, debt-adverse approach. According to TVA records, over the past five years, Monroe has been approved for rate increases of 1 percent in 2005 and .05 percent in 2007. Coupled with this dept-adverse philosophy, distributors consider cash reserves as a hedge against the risks of unforeseen costs from an aging infrastructure, potential loss of revenue from the economic impact on commercial and industrial customers, and unpredictable weather. Examples of weather events TVA distributors have incurred include damage from (1) the recent January 27, 2009, ice storm in Kentucky and Tennessee where about 130,000 of TVA distributor consumers lost their electricity and (2) tornadoes and the impact of tropical storms, such as the 2005 damage to Mississippi systems resulting from hurricane Katrina.

Monroe County EPA's response – As discussed with OIG it is Monroe County Electric Power Association's (MCEPA) operating philosophy to use a conservative, debt-adverse approach. MCEPA has provided planned capital expenditures for the next two years totaling a little over $5.0 million which would leave a cash reserve of about $2.7 million. MCEPA also provided to OIG projects that were delayed over the past two years. MCEPA had planned to build a new office building which had an estimated cost between 2 and 3 million dollars. The plans were halted because the property that MCEPA owned next to our existing office contained a house that was on a local historical registry. To this date MCEPA's management has not determined when or where the new office building will be constructed.

MCEPA does not believe a cash ratio of 5 to 8 percent is adequate enough for so many unforeseen costs that an electric utility faces. Over the past few years MCEPA as well as other utilities have faced much unpredictable weather along with escalating fuel and material cost. MCEPA prides itself in having some of the lowest rates in the Valley while at the same time maintaining adequate cash reserves that will cover any unforeseen event without any additional borrowing or cost to our members.

April 30, 2009

Robert E. Martin, ET-3C-K

RESPONSE TO DRAFT INSPECTION REPORT 2008-12007 – DISTRIBUTOR REVIEW OF MONROE COUNTY ELECTRIC POWER ASSOCIATION AND DRAFT INSPECTION REPORT 2008-12040 – DISTRIBUTOR REVIEW OF LEWISBURG ELECTRIC SYSTEM

This is in response to your memorandum dated March 31, 2009.

Agreement or disagreement with all facts, conclusions and recommendations are stated first, followed by the actions planned or taken and completion dates for each of the six recommendations

1. Revenue recognition accounting practice to be in accordance with FERC and accurate recording prepayment of power as a prepaid expense
    - Under section 1 of the Schedule of Terms and Conditions (T&C) to the wholesale power contracts, TVA requires distributors to "keep the general books of account of the electric system according to the [FERC] Uniform System of Accounts" and revenue recognition accounting practice is consistent with the requirements of the Uniform System of Accounts.
    - Section 1 of the T&C also requires distributor financial statements to be examined annually by independent CPAs in accordance with generally accepted accounting procedures (GAAP), which also allow revenue recognition accounting practices.
    - Recording prepayment of power as a prepaid expense is appropriate.
    - **Actions taken or planned, and completion dates:** TVA will rely on each distributor's annual independent auditor to verify material compliance with GAAP and the FERC Uniform System of Accounts. TVA will work with each distributor to ensure energy prepayments are classified as a prepaid expense in the distributor's FY 2009 annual financial statements. Target completion date is December 2009.

2. Work to obtain signed contracts with all customers that are above 50 kW
    - TVA management agrees that the resale schedules of the standard Schedule of Rates and Charges to wholesale contract with distributors require that retail contracts be executed with all customers whose contract demand exceeds 50 kW. TVA management finds that the contract size threshold of 50 kW was

established in 1963, and the relative customer size in 2009 versus 1963 is very different. Likewise, requiring contracts with small commercial customers is a time-consuming and difficult task which may provide little benefit for distributors or the TVA system. TVA management will recommend to the Board that a new and higher threshold be established as part of the rate change process with distributors. When the rate change is put into effect all retail customers above the new threshold will be expected to have executed contracts.

- **Actions taken or planned, and completion dates**: TVA management will recommend to the TVA Board that a higher contract demand threshold for the contract requirement be established through the rate change process. Distributors will be required to have executed retail contracts for customers with contract demands above the new threshold. Target completion date will coincide with the rate change efforts that are currently underway with the distributors and is expected to be in place by October 2010.

3. Develop a comprehensive guide on permitted expenditures and expense accrual for distributor management to use going forward

   - TVA management agrees that it is appropriate to look at permitted expenditures in the context of use of revenues provision in Section 6 of the wholesale power contract with the distributors. TVA adheres to Section 6 of the wholesale contract regarding a distributor's use of revenues, but no guidelines exist that provide an exhaustive list of permitted expenditures within electric systems. TVA management is exploring with the TVA Board the extent to which a comprehensive guideline is feasible and whether the TVA Board desires to adopt a policy that would employ such a guideline.
   - **Actions taken or planned, and completion dates**: Implementation of the recommendation in this report would require the TVA Board to develop a comprehensive guideline on permitted expenditures. TVA management will consult with the Board on the plausibility of developing and implementing policy that would employ a comprehensive guide on permitted expenditures under Section 6 of the wholesale contract. Target completion date is December 2010.

4. Review the definition of cash ratio and determine if the ratio calculation should include some or all amounts in the TVA Power Invoice Prepayment account

   - TVA agrees that it is appropriate for TVA management to review the definition of the cash ratio and determine if any adjustments are appropriate.
   - **Actions taken or planned, and completion dates**: TVA management will review the definition of the Cash Ratio and

determine if any adjustments are appropriate. Target completion date is December 2009.

5. Develop criteria to be used in determining whether a distributor's cash reserves are excessive and incorporate the criteria into the rate setting process.

    - TVA management agrees that it is appropriate for the Board to consider distributor cash reserves as part of the process under which TVA and distributors are to agree upon increases or decreases in the distributor's resale rates as provided for under Section 5 in the wholesale power contract. Under guidelines approved by the Board in 1992, TVA calculates a guideline revenue amount that governs resale rate increases to which TVA will automatically agree without further review. TVA management is making recommendations to the TVA Board that additional financial metrics, including those based on cash reserves, should be considered in determining when agreement upon a resale rate increase or decrease is appropriate.
    - **Actions taken or planned, and completion dates**. TVA management is making recommendations to the TVA Board that additional financial metrics should be employed for purposes of administering the resale rate provisions in Section 5 of the wholesale power contracts. The need to consider cash reserves will be included in TVA management's recommendations to the Board. A change in the current guidelines to include these additional financial metrics requires Board action. Target completion date is December 2010.

6. Review the requirements of the power contract and develop more definitive guidelines on how often meters should be tested.

    - TVA is moving away from end-use-wholesale rates to billing based on the wholesale meters. The accuracy of the distributor meters would then have less of a financial impact on TVA. However, meter testing protects distributors and TVA should continue to encourage it as a matter of good business practice.
    - **Actions taken or planned, and completion dates**: TVA management has been informally discussing a wholesale demand and energy rate structure with distributor representatives. TVA management expects to soon begin formal implementation of a rate change that will replace end-use wholesale rates with a structure that will be primarily based on wholesale meter data. Target completion date will coincide with the rate change efforts that are currently underway with the distributors and is expected to be in place in October 2010.

All of the above recommendations apply to the audit of the Monroe County Electric Power Association. Because of common findings in the two OIG reports, recommendations 2, 3, and 5 also apply to the Lewisburg Electric System review.

Kimberly S. Greene

Kimberly S. Greene
Chief Financial Officer and
Executive Vice President, Financial Services
WT 7B-K

VB:JD
cc: Peyton T. Hairston, Jr., WT7B-K
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May 12, 2009

Robert E. Martin, ET-3C-K

AMENDMENT TO RESPONSE TO ITEM NUMBER 6 -- DRAFT INSPECTION REPORT 2008-12007 – DISTRIBUTOR REVIEW OF MONROE COUNTY ELECTRIC POWER ASSOCIATION AND DRAFT INSPECION REPORT 2008-12040– DISTRIBUTOR REVIEW OF LEWISBURG ELECTRIC SYSTEM

This serves as an amendment to our response dated April 30, 2009, to item number 6 in your memorandum dated March 31, 2009.

6. Review the requirements of the power contract and develop more definitive guidelines on how often meters should be tested.

    - TVA is moving away from end-use-wholesale rates to billing based on the wholesale meters. The accuracy of the distributor meters would then have less of a financial impact on TVA. However, meter testing protects distributors and TVA should continue to encourage it as a matter of good business practice.
    - **Actions taken or planned, and completion dates**: TVA management has been informally discussing a wholesale demand and energy rate structure with distributor representatives. TVA management expects to soon begin formal implementation of a rate change that will replace end-use wholesale rates with a structure that will be primarily based on wholesale meter data. Target completion date will coincide with the rate change efforts that are currently underway with the distributors and is expected to be in place in October 2010. The power contracts do not address the frequency of meter testing. TVA views this as a utility standards issue for the distributor. However, TVA will work with the distributor group TVPPA to develop recommendations on common meter testing criteria. Target completion date for common meter testing criteria is October 2010.

John G. Trawick

for
Kimberly S. Greene
Chief Financial Officer and
Executive Vice President, Financial Services
WT 7B-K

VB:JSE
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