



Memorandum from the Office of the Inspector General

December 9, 2010

Kimberly S. Greene, WT 7B-K

**REQUEST FOR FINAL ACTION – AUDIT 2009-12699 – FOLLOW-UP REVIEW OF
TVA'S ROLE AS A RATE REGULATOR – USE OF ELECTRIC SYSTEM REVENUES
FOR NONELECTRIC PURPOSES**

Attached is the subject final report for your review and action. Your written comments, which addressed your management decision and planned actions, 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 Jill M. Matthews, Deputy Assistant Inspector General, Audits and Support, at (865) 633-7430. We appreciate the courtesy and cooperation received from your staff during the audit.

Robert E. Martin

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Attachment

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OIG File No. 2009-12699



Office of the Inspector General

Audit Report

To the Group President,
Strategy and External
Relations

FOLLOW-UP REVIEW OF TVA'S ROLE AS A RATE REGULATOR – USE OF ELECTRIC SYSTEM REVENUES FOR NONELECTRIC PURPOSES

Audit Team
Richard C. Underwood
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Audit 2009-12699
December 9, 2010

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Audit 2009-12699 – Follow-Up Review of TVA’s Role as a Rate Regulator – Use of Electric System Revenues for Nonelectric Purposes

EXECUTIVE SUMMARY

Background

The Tennessee Valley Authority (TVA) sells power to 155 distributors in the seven-state TVA area. TVA’s regulatory authority is exercised through the terms and conditions included in TVA’s individual Wholesale power contracts with the distributors. Over the years, the TVA Boards of Directors, using their discretionary authority, incorporated provisions in the power contracts consistent with the statutory requirements and objectives of the TVA Act, such as how revenues from electric system operations can be spent.

On June 13, 2006, the Office of the Inspector General (OIG) issued Inspection 2005-5221, Review of TVA’s Role as a Rate Regulator. In this review, we discussed, among other things, that:

- Some TVA distributors were using electric system revenues to fund new business ventures, such as telephone, cable TV, and Internet services, without proper contract modifications in place and, in some cases, without TVA approval.
- TVA did not have formalized procedures in place to ensure consistent review of (1) distributor financial information, including when a distributor’s revenue was more than sufficient for the operation and maintenance of the electric system, so that TVA could work with the distributor to lower resale rates or reduce proposed rate increases by the distributor and (2) business plans that propose use of electric system revenues for nonelectric purposes.

We recommended (and TVA management agreed) to ensure contract modifications were executed for any distributors approved to use electric system revenues for nonelectric purposes. In addition, TVA management asserted they would formalize procedures to ensure consistent review of (1) distributor financial information and (2) business plans that propose the use of electric system revenues for nonelectric purposes.

The objective of this review was to determine if contract modifications had been executed and other recommendations from Inspection 2005-5221 had been implemented in relation to TVA approvals for distributors to use electric system revenues for nonelectric purposes. The scope of our review was for the period July 2006 through June 2009.

What the OIG Found

In OIG’s Inspection 2005-5221, we recommended TVA execute contract modifications with distributors who wish to pursue nonelectric business ventures, and TVA

management agreed to do so. However, TVA management later decided on an alternative approach to protect its interests and the interests of all parties. Instead of formal contract modifications, TVA's approach now is to require written agreementsⁱ with terms to protect the distributors, ratepayers, and TVA when approving the distributor to invest "reserves for renewals, replacements, contingencies, and working capital" in nonelectric business ventures. TVA management believes this approach and the resulting agreements provide greater protections for the involved parties.

TVA has designated the request evaluation and subsequent agreements for one distributor in 2008 as the "model" for handling future requests. While the new approach and "model" may prove effective for controlling risks, we noted areas where protection for the distributors, ratepayers, and TVA could be strengthened. Specifically, we found TVA has:

- Not documented guidelines for (1) reviewing business plans when a distributor proposes to invest in nonelectric ventures or use electric system revenues for nonelectric purposes and (2) the terms to be included in the resulting formal written agreements.
- Not established guidelines to indicate when a distributor's cash reserves becomes excess revenues that should be returned to the ratepayer through rate reductions, as required by the power contract. TVA has made some progress in formalizing procedures and metrics for review of a distributor's financial position; however, the procedures and metrics have not been approved and implemented. According to TVA management, there have been 11 rate reductions and 10 absorptions of wholesale rate increases or fuel cost adjustments by 13 distributors during the period October 1, 2006, through July 8, 2010.
- Not reviewed distributors previously approved to use electric system revenues for nonelectric purposes or those using funds without approval to determine if appropriate protections (e.g., formal written agreements) are in place.

What the OIG Recommends

We recommend the Group President, Strategy and External Relations, (1) formally document procedures and guidelines for evaluating distributor requests to invest in nonelectric ventures or use electric system revenues for nonelectric purposes, including acceptable limits for certain elements, (2) determine when distributor reserves become excessive and should be returned to the ratepayers in the form of rate reductions, and (3) ensure all distributors using electric system revenues for nonelectric purposes have appropriate protections in place.

ⁱ TVA's 2008 evaluation of the business plan and distributor's financial position and resulting formal written agreements for one distributor was identified as the "model" for future requests. The written agreements in TVA's "model" were in the form of an interdivisional loan agreement and joint use of funds agreement. The interdivisional loan agreement was signed by TVA, the distributor, and a representative for the other division/department. The joint use agreement was signed by TVA and the distributor.

Management's Comments

TVA management generally agreed with and is taking actions to address our recommendations. See Appendix B for TVA's complete response.

Auditor's Response

The OIG concurs with the planned actions to correct the identified issues.

BACKGROUND

The Tennessee Valley Authority (TVA) sells power to 155 distributors in the seven-state TVA area. TVA's regulatory authority is exercised through the terms and conditions included in TVA's individual Wholesale power contracts with these 155 distributors. The basis for the terms and conditions included in the contracts can be found in the TVA Act. One primary objective of the TVA Act shown in Section 15d.(f) states, "power shall be sold at rates as low as are feasible." Over the years, the TVA Boards of Directors, using their discretionary authority, incorporated provisions in the power contracts consistent with the statutory requirements and objectives of the TVA Act, such as (1) resale rates and ensuring consumers are charged the same as others in their class, (2) operating the system on a self-supporting and financially sound basis, (3) how revenues for electric system operations can be spent,¹ and (4) required accounting practices.

In Office of the Inspector General's (OIG) Inspection 2005-522I, Review of TVA's Role as a Rate Regulator, issued June 13, 2006, we discussed, among other things, that:

- Some TVA distributors were using electric system revenues to fund new business ventures, such as telephone, cable TV, and Internet services, without proper contract modifications in place and, in some cases, without TVA approval.
- TVA did not have formalized procedures in place to ensure consistent review of (1) distributor financial information, including when a distributor's revenue was more than sufficient for the operation and maintenance of the electric system, so that TVA could work with the distributor to lower resale rates or reduce proposed rate increases by the distributor and (2) business plans that propose use of electric system revenues for nonelectric purposes.

We recommended (and TVA management agreed) to ensure contract modifications were executed for any distributors approved to use electric system revenues for nonelectric purposes. In addition, TVA management asserted they would formalize procedures to ensure consistent review of (1) distributor financial information and (2) business plans that propose the use of electric system revenues for nonelectric purposes. The planned completion date for these actions was originally December 31, 2006; however, TVA is still working to complete these actions.

¹ Section 5(c) of the power contract with distributors of TVA power states, "If the rates and charges in effect at any time provide revenues that are more than sufficient for such purposes, as more particularly described in Section 6 hereof, the parties shall agree upon a reduction in said rates and charges, and Municipality shall promptly put such reduced rates and charges into effect."

The uses allowed for excess revenues under Section 6 of the power contract include (1) current electric system operating expenses and payments of principal and interest on system indebtedness, (2) funding reasonable reserves for renewals, replacements, contingencies, and working capital to cover operating expenses for a reasonable number of weeks, (3) tax equivalent payments to general funds, (4) new electric system construction, and (5) retirement of system indebtedness prior to maturity.

FINDINGS

In OIG's Inspection 2005-522I, we recommended TVA execute contract modifications with distributors who wish to pursue nonelectric business ventures, and TVA management agreed to do so. However, TVA management later decided on an alternative approach to protecting its interests and the interests of all parties. Instead of formal contract modifications, TVA's approach now is to require written agreements, such as a joint use agreement and an interdivisional loan agreement, with terms to protect the distributors, ratepayers, and TVA when a distributor is approved to invest reserves² in nonelectric business ventures. TVA management believes this approach and the resulting agreements provide greater protections for the involved parties.

While reviewing this new approach, we noted areas where TVA could improve the review process for requests. Specifically, we found TVA has not documented (1) detailed procedures and guidelines to be used when evaluating business plans when a distributor proposes to invest in nonelectric ventures or use electric system revenues for nonelectric purposes or (2) the terms to be included in the resulting formal written agreements. In addition, we noted TVA has made progress in formalizing procedures for review of a distributor's financial position; however, TVA still needs to develop additional guidance to determine when a distributor's cash reserves are excessive. Finally, we found TVA could take steps to review all distributors using electric system revenues for nonelectric purposes to ensure formal written agreements are established with the appropriate protections for the distributors, ratepayers, and TVA. These items are discussed in detail below.

EXECUTION OF CONTRACT MODIFICATIONS FOR DISTRIBUTORS ALLOWED TO USE ELECTRIC SYSTEM REVENUES FOR NONELECTRIC PURPOSES

Subsequent to the prior Inspection report, TVA management decided not to execute contract modifications with distributors who wish to pursue nonelectric business ventures. Instead, TVA elected to use an approach in which TVA approves distributors' investment of their reserve funds in these business ventures and establishes formal written agreements with terms to protect the distributors, ratepayers, and TVA.

TVA received six distributor requests to use electric system revenues for nonelectric purposes during our audit period. TVA's 2008 evaluation of the business plan and distributor's financial position and resulting formal written agreements for one distributor was identified as the "model" for future requests. In this model case, two supplements to the power contract in the form of an

² Section 6 of the power contract describes the approved uses of electric system revenues that include reasonable reserves for renewals, replacements, contingencies, and working capital to cover operating expenses for a reasonable number of weeks.

interdivisional loan agreement and a joint use of funds agreement were executed.³ In the interdivisional loan agreement, we noted TVA included several items that could help protect the interests of the distributors, ratepayers, and TVA, such as:

- Specific terms for recourse by the electric system if the line of business invested in did not succeed as projected.
- A cap on the potential loan amount.
- Guidelines for setting the interest amount at which the loan was to be repaid as well as dates on which payments were to be made to the electric system.

TVA management stated the new approach and the resulting formal written agreements provide greater protections to the involved parties than the previous practice of modifying the contracts. TVA personnel stated the intent for investing distributor reserves is to benefit the electric system, and the new approach makes these investments safer for the ratepayers because TVA's contracts are more restrictive and require a higher interest rate than Tennessee state law. In addition, the loan made in the model approach is callable when necessary and is part of the interdivisional loan agreement signed by TVA, the distributor, and the municipality's Chief Executive. TVA believes this type of agreement to be stronger and more enforceable. We found this approach was allowable under the terms of the power contract and does provide protections for the involved parties. If implemented properly, it could be as effective as or more effective than the previous practice of modifying the contracts in protecting the interests of the various parties.

EVALUATING REQUESTS FOR THE INVESTMENT OR USE OF ELECTRIC SYSTEM REVENUES FOR NONELECTRIC PURPOSES

As discussed previously, TVA management used the review of one distributor's request in 2008 as the "model" for the evaluation of future requests. However, we noted TVA has yet to document (1) detailed procedures and guidelines to be used when evaluating distributor requests (e.g., business plans that propose the investment or use of electric system revenues for nonelectric purposes and financial position) and (2) terms to be included in the resulting formal written agreements once the request is approved. Furthermore, we identified opportunities to strengthen the business plan review and documentation of the review as described on the following page.

³ However, the agreements required to protect the electric department, ratepayers, and TVA may vary based on the situation.

In reviewing the model business plan evaluation, we noted TVA considered several important criteria when performing their review of distributor business plans, including:

- Whether the proposed investment had received approval by the City Council or other public hearing authority.
- Whether a review had been performed by the State Comptroller.
- The proposed uses of electric system revenues.
- Whether the proposed interest rate on proposed loans met minimum requirements under state law.
- The distributor's current credit rating.
- Results of a TVA performed investment analysis that included:
 - Net present value of the proposed investment
 - Payback in years
 - Benefit/cost ratio
 - Expected internal rate of return on the investment
- Comparison of results of a TVA-performed review of financial ratios to all distributors and similar distributors.
- Proposed method for allocating joint costs.
- Comparison of the distributor's current rate ranking to the distributor's rate ranking under the worst case scenario where no benefits are derived from the investment.

However, we found this process could be improved in key areas. Specifically, TVA's analyses appeared to be performed based on the assumption that information provided by the distributor was accurate and did not evaluate the accuracy of the distributor's business plan projections or the likelihood distributor targets will be met. In addition, while TVA's review of business plans considers the following items, it does not appear TVA has developed guidelines that document what is acceptable in terms of the:

- Level of risk for distributor investments or how to evaluate this risk.
- Payback term for loaned amounts.
- Rate of return for the electric system.
- Level of impact on rates.

Also, we did not find documentation that the evaluation included consideration of:

- The ability of the business venture to obtain other financing in case the electric division must call the loan. If the business does not have the ability to obtain additional financing when the electric system needs its reserve funds, there is no protection for the ratepayers provided by the callable portion of the loan agreements.

- Previous amounts the electric division was allowed to loan to other distributor business ventures or if those business ventures had achieved the goals established by the distributor in its previous request.

Finally, we noted documentation of the reasons TVA management approved the “model” request was not complete in one area. Specifically, TVA’s evaluation of the distributor’s business plan indicated even with the most desirable outcome there would be a need for an additional rate increase of 1.8 percent. Our review of documentation provided by TVA did not note the specific reason or reasons that led TVA to approve a proposed business plan that would increase rates under the best of outcomes. However, it was documented in the evaluation of the business plan proposal the plan was predicated on the distributor’s assertion that it would be making the significant investment in the fiber backbone for the purposes of an Automatic Metering Infrastructure⁴ network, and the incremental investment to support the competitive broadband business was an opportunity to realize additional revenues and reduce the overall costs to the electric system.

GUIDELINES FOR REVIEW OF DISTRIBUTOR FINANCIAL POSITION AND DETERMINATION OF EXCESS CASH

In Inspection 2005-5221, we noted there had been no guidelines established for the ratios used in the financial analysis of distributors performed by TVA to indicate when a distributor’s rates and charges produce revenues more than sufficient for the operation and maintenance of the electric system on a self-supporting and financially sound basis. Additionally, we recommended in individual distributor audits issued in 2009 and 2010, TVA 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 has been developing procedures for the Board’s approval regarding new metrics for use in analyzing a distributor’s financial position in relation to the resale rates charged to customers. Management is expecting to receive the Board’s approval on these new metrics in 2010. However, TVA has not developed guidance to determine when a distributor’s level of reserves becomes excessive and should be returned to the ratepayer in the form of rate reductions and a procedure on how to accomplish the prompt return to the ratepayers. This guidance is necessary to consistently carry out the provision in Section 5(c), Resale Rates, of the power contract that states:

If the rates and charges in effect at any time provide revenues that are more than sufficient for such purposes, as more particularly

⁴ Automatic Metering Infrastructure (AMI) systems measure, collect, and analyze energy usage from advanced devices, such as electricity meters, gas meters, and/or water meters, through various communication media on request or on a predefined schedule. With this technology, utilities can remotely read your meter, obtain detailed information regarding your energy use, and monitor power quality. AMI also enables utilities to incorporate advanced metering applications, such as time-of-use rates.

described in Section 6 hereof, the parties shall agree upon a reduction in said rates and charges, and Municipality shall promptly put such reduced rates and charges into effect.

According to TVA management, there have been 11 rate reductions and 10 instances when a distributor has chosen to absorb all or part of a Wholesale rate increase or fuel cost adjustment by 13 distributors during the period October 1, 2006, through July 8, 2010 (see Table below). TVA management indicated that all but one of the rate reductions were initiated by the distributor.

**Distributor Rate Reductions or Absorptions of
Wholesale Rate Increases or Fuel Cost Adjustments
for the Period October 1, 2006, Through July 8, 2010**

Distributor	Date	Rate Reduction		Absorbed Wholesale Increases or Fuel Cost Adjustments	
		Amount	Percent	Amount	Percent
Jellico Electric and Water System	01/01/07			\$9,498	0.13%
	10/01/07			\$79,190	1.10%
	01/01/08			\$140,522	1.90%
	04/01/08			\$175,600	2.80%
Hickman-Fulton Rural Electric Cooperative Corporation	10/01/05			\$50,000	0.66%
	01/01/10	\$73,465	0.81%		
McMinnville Electric System	10/01/06	\$20,357	0.13%		
	01/01/08	\$9,026	0.05%		
	01/01/10	\$28,201	0.16%		
East Mississippi Electric Power Association	08/01/07			\$7,088	0.03%
	11/01/07			\$76,633	0.35%
	01/01/08			\$57,752	0.26%
Newport Utilities	10/01/05			\$41,237	0.12%
Russellville Electric Plant Board	04/01/06			\$250,000	3.00%
Mountain Electric Cooperative	04/01/06	\$433	0.00%		
Powell Valley Electric Cooperative	10/01/06	\$4,728	0.01%		
Tri-County Electric Membership Cooperative	10/01/06	\$194	0.00%		
Duck River Electric Membership Cooperative	04/01/07	\$179,000	0.15%		
Lexington Electric System	02/01/08	\$217,315	0.58%		
Harriman Utility Board	11/01/08	\$609,800	2.70%		
Somerville Utility Board	04/01/10	\$42,197	1.00%		

REVIEW OF ALL DISTRIBUTORS USING ELECTRIC SYSTEM REVENUES FOR NONELECTRIC PURPOSES

While performing audits of distributors and in our original inspection, we noted distributors who either are using electric system revenues for nonelectric purposes without approval from TVA or were approved previously without putting proper agreements in place. For example, in a previous distributor audit, we noted the distributor was approved to invest in a nonelectric business but there were no loan documents generated, and the interest rate to be paid to the electric system had not been determined. In another audit, we found the electric system was paying all of the expenses for the other line of business and keeping a running total of the amounts due to the electric system. No documents providing recourse by the electric system against these other lines of business in the event of nonpayment were available. As a result, the electric system and ratepayers were not adequately protected if the nonelectric business did not succeed or the electric system needed to retrieve its funds.

As noted earlier, TVA has stated future approvals will include proper agreements with all parties to ensure the electric system revenues are protected. However, we did not see evidence TVA planned to look at those previously approved or those using funds without approval to ensure proper agreements are in place with protections for the involved parties.

RECOMMENDATIONS

We recommend the Group President, Strategy and External Relations:

1. Formally document procedures and guidelines for evaluating distributor requests to invest in nonelectric ventures or use electric system revenues for nonelectric purposes, including acceptable limits for certain elements, Include steps on how to determine acceptable limits/levels for certain elements, such as:
 - Maximum allowable cash reserves for renewals, replacements, contingencies, and working capital.
 - Identification of acceptable levels of risk in consideration of business plans for nonelectric investments or how to evaluate the risk.
 - Identification of acceptable levels of rate increases required as a result of the investment.
 - Specific time frames that are acceptable for payback of electric system investments.
 - Specific acceptable levels of rate of return on electric system investments in nonelectric lines of business.

- Consideration of previous uses of electric system revenues for nonelectric purposes by the distributor and whether or not those projects obtained their stated goals.

TVA Management's Comments – TVA management stated that after review and consideration of the recommendations contained in the OIG's memorandum dated August 24, 2010, it concluded that ratepayers could indeed be further protected if increased review of the business plans for any operation proposed by a distributor for an interdivision loan was implemented as a part of TVA approving any interdivision loans in the future. TVA will look at all of the OIG criteria and use them as appropriate to determine if any particular interdivision loan may put the electric ratepayers at risk inconsistent with the use-of-revenue provisions of the power contract notwithstanding the other protections of the interdivision loan agreements. In addition, more careful review of the business plans should assist TVA in reviewing the adequacy of the in-lieu of tax payments as collateral for the loan interest and principal. See Appendix B for TVA's complete response. After submitting its official response, TVA later informed us it plans to have baseline criteria/steps for evaluating distributor business plans developed by February 28, 2011.

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

2. When seeking the Board's approval for new metrics to use in evaluating a distributor's financial position, also include when a distributor's level of "reasonable reserves for renewals, replacements, contingencies, and working capital" becomes excessive and should be returned to the ratepayer in the form of rate reductions. Also, TVA should document a procedure on how to accomplish the prompt return to the ratepayers.

TVA Management's Comments – TVA management will present additional metrics to the TVA Board in the coming year for review and approval. TVA evaluates the distributor's level of reasonable reserves when the distributors request rate actions. An annual evaluation of all distributor financials looking at key ratios and trends will be proposed to the Board. Based on this review, TVA will contact distributors who may need to reduce rates or, conversely due to poor ratios, may need to increase rates. The target date for completing discussions with distributors and submitting revised policies for Board approval is November 2011. See Appendix B for TVA's complete response.

Auditor's Response – The OIG concurs with management's plan to develop guidelines for determining when a distributor's level of reserves becomes excessive and submitting them to the Board for approval.

3. Review and ensure all distributors using electric system revenues for nonelectric purposes have formal written agreements (e.g., joint use of cash, interdivisional loan, etc.) in place to properly protect the electric department in

the event the nonelectric business venture does not succeed or provide payback to the electric system in a reasonable period of time.

TVA Management's Comments – TVA management stated agreements are in place in those situations where TVA has consented to the use of electric system revenues for nonelectric purposes. As described more fully in the first response listed above, TVA has no plans to enter into agreements where distributors have used electric system revenues for nonelectric purposes without TVA's consent. In such cases, TVA will work with the distributor as appropriate to bring the distributor into compliance with the power contract. TVA distributor staff will look for electric system use of revenue for nonelectric purposes when they perform their annual review of distributor financial information. As part of this review, any unapproved use of electric system revenues for nonelectric purposes will be evaluated for further action. Target completion date for this is September 2011. See Appendix B for TVA's complete response.

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

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our review was to determine if contract modifications had been executed and other recommendations from Inspection 2005-5221 had been implemented in relation to TVA approvals for distributors to use electric system revenues for nonelectric purposes. The scope of our review was for the period July 2006 through June 2009. Fieldwork was conducted between July 2009 and May 2010.

To achieve our objective, we:

- Obtained listings of all distributors with nonelectric services or business operations added after July 1, 2006.
- Determined if the new services identified were funded by electric system revenues or by other funding sources.
- Requested contract modifications documenting TVA approval of nonelectric services being supported by electric system revenues.
- Determined if TVA provided approval of the use of electric system revenues through some other medium (e.g., memorandum, letter, etc.) for any services supported by electric system revenues where a contract modification was not present.
- Reviewed the distributor business plan evaluation and approval process used by TVA management identified as the “model” for all future requests for investment of electric system reserves in a nonelectric line of business.
- Requested documented procedures and guidelines for review of distributor financial position and proposed distributor business plans.

This performance audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

November 16, 2010

Robert E. Martin, ET 3C-K

UPDATED RESPONSE TO THE FIRST RECOMMENDATION IN DRAFT AUDIT REPORT 2009-12699 – FOLLOW UP REVIEW OF TVA'S ROLE AS A RATE REGULATOR -- USE OF ELECTRIC SYSTEM REVENUES FOR NONELECTRIC SYSTEM PURPOSES

RECOMMENDATION:

1. Formally document procedures and guidelines for evaluating the distributor's business plan and performing analyses on the distributor's financial information when a distributor requests to use electric system revenues for nonelectric system purposes. Include steps on how to determine acceptable limits/levels for certain elements, such as:
 - Maximum allowable cash reserves for renewals, replacements, contingencies, and working capital.
 - Identification of acceptable levels of risk in consideration of business plans for nonelectric investments or how to evaluate the risk.
 - Identification of acceptable levels of rate increases required as a result of the investment.
 - Specific time frames that are acceptable for payback of electric system investments.
 - Specific acceptable levels of rate of return on electric system investments in nonelectric system lines of business.
 - Consideration of previous uses of electric system revenues for nonelectric system purposes by the distributor and whether or not those projects obtained their stated goals.

TVA MANAGEMENT RESPONSE:

In the Office of the Inspector General (OIG) report, the "interdivision loan agreements" (discussed by management below as "actions taken") are correctly described as management's "alternative approach" (Executive Summary, line 2, page ii) and as management's "model" or "new approach" (report pages 2 and 3). However, the interdivision loan agreements are not being used as a way of approving electric system business plans for nonelectric system ventures. TVA management is no longer entertaining or granting "distributor requests to use electric system revenues for nonelectric system purposes."

In order to protect ratepayers, including protecting them from risks of other business ventures in which a distributor might lawfully be involved, using electric system revenues for nonelectric system purposes is prohibited by the power contract. Accordingly, TVA has discontinued the practice that was sometimes employed by previous management of allowing exceptions to the power contract requirements by entering into agreements for distributors to use electric system revenues for specified nonelectric system purposes that were viewed as providing an indirect benefit to the electric system.

Robert E. Martin
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The OIG recommendations for "evaluating a distributor's business plan [for the nonelectric system venture] and performing analyses on the distributor's financial information" were originally made in the context of TVA approving distributor requests "to use electric system revenues for nonelectric system purposes." Management agreed with those recommendations but they were never fully implemented because management ultimately concluded that the practice itself is not consistent with the policy reflected in the use of revenues provisions of the wholesale power contract. Even if business plans were more carefully and fully reviewed, the electric ratepayers would not be protected in the way and to the extent that prohibiting the use of electric system revenues for nonelectric system purposes protects the ratepayers.

Management initially concluded that the interdivision loan agreements (discussed by management below under actions taken) did not require that there be a careful and detailed analysis by TVA of the business plans for the nonelectric operations for which the funds are being loaned. That is because, unlike the agreements creating exceptions to the power contract that were the subject of the OIG's original recommendations in this audit, interdivision loan agreements are not primarily dependent upon the success of the nonelectric operations to protect ratepayers. Rather, as described below, interdivision loan agreements assure that electric ratepayers are fully secured for the loans. Given that security, the protection of electric ratepayers is not primarily dependent upon either TVA or the distributor making correct business judgments about the long-term viability of the nonelectric operations to which the funds are loaned. Rather, if the operations turn out not to be viable such that principal and interest cannot be paid on the loan when due, the electric system simply can withhold in-lieu-of tax payments to keep the electric system whole. Under these arrangements, it is ultimately the distributor's general or other funds, not electric system funds, that are at risk from the operations to which the loan is made; the electric system ratepayers do not take on risk under these arrangements, rather the risk is properly borne by the taxpayers or by "ratepayers" for other services that are not regulated by TVA. The protection of the ratepayers is not dependent upon the ability of the nonelectric business "to obtain additional financing when the electric system needs its reserve funds." (OIG report, last bullet, page 4.) However, after review and consideration of the recommendations contained in the OIG's memorandum dated August 24, 2010, management has concluded that ratepayers could indeed be further protected if increased review of the business plans for any operation proposed by a distributor for an interdivision loan were implemented as a part of TVA approving any interdivision loans in the future. OIG has outlined certain criteria for evaluating business plans such as maximum cash reserves and acceptable levels of risk. TVA will look at all of the OIG criteria and use them as appropriate to determine if any particular interdivision loan may put the electric ratepayers at risks inconsistent with the use-of-revenue provisions of the power contract notwithstanding the other protections of the interdivision loan agreements. Putting trigger values for these criteria as OIG has suggested is difficult to do since they have to be evaluated in the context of the particular business plan and distributor specific facts. For example, TVA would not approve an interdivision loan if review of the business plan showed it to be likely that there would be a default on the loan. In addition, more careful review of the business plans should assist TVA in reviewing the adequacy of the in-lieu of tax payments as collateral for the loan interest and principal.

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Actions taken or planned, and completion dates: TVA does continue to put agreements in place to help ensure compliance with the standard use of revenues provisions in section 6 of the power contract and other standard provisions of the power contract. The agreements are intended to help to prevent misuse of electric system funds or assets in violation of standard power contract provisions.

For example, TVA has entered into joint use agreements to cover the arrangements under which a distributor's electric system and its other nonelectric operations jointly use an electric system asset. The standard provisions of the power contract expressly provide for "joint use" agreements, stating that "[i]n the interest of efficiency and economy . . . property and personnel [may be used] jointly for the electric system and other operations, subject to agreement between [Distributor] and TVA as to appropriate allocations, based on direction of effort, relative use, or similar standards, of any and all joint investments, salaries and other expenses, funds, or use of property or facilities."

Furthermore, TVA also enters into agreements whereby distributors make appropriate investments of their reserve funds. Such an agreement serves the purpose of carrying out standard provisions of the power contract. Specifically, under section 6 of the power contract, a permitted use of revenues is "reasonable reserves for renewals, replacements, and contingencies."

Of course, where distributors have such reasonable reserves, they are typically held in an interest bearing bank account. Other investment of the reserves is appropriate so long as the funds can be accessed when needed for the other electric system purposes allowed by the power contract and ratepayers are otherwise protected from investment risks. To assure that such protections are in place for situations where reserve funds are invested in nonelectric operations of the distributor, TVA and distributors have developed interdivision loan agreements under which a distributor's electric department can loan electric system reserves to other operations that might only indirectly benefit the electric system uses if adequate protections exist for the electric system in loaning these funds. An interdivision loan agreement helps assure that such loans are fair to electric system ratepayers by addressing the interest to be charged on the loans and the security to be provided for the loans. Typically, it requires the loans to be at an interest rate more protective of the electric system than the rate required by state law and for the loans to be secured by an electric system right to withhold tax equivalent payments in the event of a loan default. In addition, the loans should be callable by the electric system if the reserve funds are needed. This would include using the reserve funds to reduce rates if a determination were later made that the amount of the reserves were unreasonable. With these protections in place and with more careful review of business plans based on the OIG recommendations, interdivision loans can provide greater benefits to the electric system than the investment of reserve funds a distributor might otherwise make.

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RECOMMENDATION:

2. When seeking the Board's approval for new metrics to use in evaluating a distributor's financial position, also include when a distributor's level of "reasonable reserves for renewals, replacements, contingencies, and working capital" becomes excessive and should be returned to the ratepayer in the form of rate reductions. Also, TVA should document a procedure on how to accomplish the prompt return to the ratepayers.

TVA MANAGEMENT RESPONSE:

TVA management agrees that Board approval is required to change the process of rate approvals. Proposed revisions to the process for reviewing distributor requests for rate levels or structure changes have been developed and are being submitted for review and action by the Board.

Actions taken or planned, and completion dates: TVA staff will present additional metrics to the TVA Board in the coming year for review and approval. TVA evaluates the distributor's level of reasonable reserves when the distributors request rate actions.

TVA evaluates rates requests on a case-by-case basis, using several factors before approving the rate request (unless they are under guideline amounts), and if the rate increases are not supported by good rationale, TVA would work with the distributor to postpone or reduce rates to keep rates as low as possible. In addition, an annual evaluation of all distributor financials looking at key ratios and trends will be proposed to the Board. Based on this review, TVA will contact distributors that may need to reduce rates or conversely due to poor ratios, may need to increase rates. For the reasons noted above, the interdivision loan agreements do not preclude a determination that reserves need to be reduced and will not prevent distributors from doing so if such a determination is made.

The additional metrics for rate requests as well as the annual review of distributor financials are processes that have to be approved by the Board and accepted by the distributors. TVA has already started preliminary discussions with the Tennessee Valley Public Power Association on the need for changes to the manner in which TVA evaluates rate requests and distributor financials. The target date for completing discussions with distributors and submitting revised policies for Board approval is November 2011.

RECOMMENDATION:


3. Review and ensure all distributors using electric system revenues for nonelectric system purposes have formal written agreements (e.g., joint use of cash, interdivisional loan, etc.) in place to properly protect the electric department in the event the nonelectric business venture does not succeed or provide payback to the electric system in a reasonable period of time.

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TVA MANAGEMENT RESPONSE:

Agreements are in place in those situations where TVA has consented to the use of electric system revenues for nonelectric system purposes. As described more fully in response number 1 above, TVA has no plans to enter into agreements where distributors have used electric system revenues for nonelectric system purposes without TVA's consent. In such cases, TVA will work with the distributor as appropriate to bring the distributor into compliance with the power contract.

Actions taken or planned, and completion dates: TVA distributor staff will look for electric system use of revenue for nonelectric system purposes when they perform their annual review of distributor financial information. As part of this review, any unapproved use of electric system use of revenues for nonelectric system uses will be evaluated for further action. Target completion date for this is September 2011.



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