Memorandum from the Office of the Inspector General

January 4, 2011

Kimberly S. Greene, WT 7B-K

REQUEST FOR FINAL ACTION – AUDIT 2010-13025 – DISTRIBUTOR REVIEW OF NORTH GEORGIA ELECTRIC MEMBERSHIP CORPORATION

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, or wish to discuss our findings, please contact Richard C. Underwood, Project Manager, at (423) 785-4824 or Melissa M. Neusel, Acting Director, Distributor Audits, at (865) 633-7357. We appreciate the courtesy and cooperation received from your staff during the audit.

Robert E Martin

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

RCU:HAC
Attachment
cc (Attachment):
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OIG File No. 2010-13025

Office of the Inspector General

Audit Report

To the Group President, Strategy and External Relations

DISTRIBUTOR REVIEW OF NORTH GEORGIA ELECTRIC MEMBERSHIP CORPORATION

Audit Team
Richard C. Underwood
Jessica L. Monroe
Stephanie L. Simmons

Audit 2010-13025
January 4, 2011

ACRONYMS AND ABBREVIATIONS

FY	Fiscal Year
kW	Kilowatt
NGEMC	North Georgia Electric Membership Corporation
OIG	Office of the Inspector General
RUS	Rural Utilities Services
TVA	Tennessee Valley Authority

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APPENDICES

Audit 2010-13025 – North Georgia Electric Membership Corporation

EXECUTIVE SUMMARY

Why the OIG Did This Review

As part of the annual audit plan, the OIG (Office of the Inspector General) performed a review of North Georgia Electric Membership Corporation (NGEMC), which is a distributor for Tennessee Valley Authority (TVA) power based in Dalton, Georgia. Annual revenues from electric sales were approximately $232 million in fiscal year 2009. The objective of the review was to determine compliance with key provisions of the power contract between TVA and NGEMC.

What the OIG Found

Our review of NGEMC found improvements were needed in the area of customer classification. We identified 34 customer accounts not classified correctly. We estimated the monetary effect of the classification issues and found it would not be significant. However, there are qualitative issues that are significant due to their systemic nature. Some of the misclassifications identified resulted from (1) an ongoing NGEMC policy to classify separately metered well pumps serving residences as residential rather than commercial and (2) a discontinued policy to classify any facility that had living quarters, including group homes and cabins, owned by individuals and/or organizations as residential.

In addition, we found, as of June 30, 2009, NGEMC's cash ratio was about 2 percent, which is less than TVA's established guidelines for adequate cash reserves of 5 to 8 percent. Finally, we identified opportunities to enhance TVA's oversight of the distributors that were also reported in previous distributor audits. TVA is in the process of addressing these findings regarding (1) the lack of guidance for distributors on what constitutes prudent expenditures and (2) defining the process for granting the Small Manufacturer Credit.

What the OIG Recommends

We recommend the Group President, Strategy and External Relations, work with NGEMC to (1) remediate classification issues and (2) modify the NGEMC policy regarding classification of well pumps serving a residence.

Management's Comments

NGEMC and TVA management agreed with our recommendations and have taken or are taking actions to address the recommendations. The target completion date for all corrective actions is December 2011. See Appendix B for NGEMC's complete response and Appendix C for TVA's complete response.

Auditor's Response

The OIG concurs with actions taken and planned by NGEMC and TVA to correct the identified issues.

BACKGROUND

North Georgia Electric Membership Corporation (NGEMC) is a distributor for Tennessee Valley Authority (TVA) power based in Dalton, Georgia, with revenues from electric sales of approximately $232 million in fiscal year (FY) 2009. 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, manufacturing, and lighting. Within these classes are various rate classifications based on the customer type and usage. Table 1 shows the customer mix for NGEMC as of June 2009.

NGEMC's Customer Mix as of June 2009

Customer Classification	Number of Customers	Revenue	Kilowatt Hours Sold
Residential	84,256	$ 137,938,807	1,464,428,857
General Power – 50 Kilowatt (kW) and Under (Commercial)	12,354	15,916,956	138,822,729
General Power – Over 50 kW (Commercial or Manufacturing)	1,136	71,865,287	875,984,931
Street and Athletic	205	200,665	2,621,883
Outdoor Lighting[1]	543	3,252,437	21,221,828
Unbilled Revenue		2,940,262	
Total	**98,494**	**$ 232,114,414**	**2,503,080,228**

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. NGEMC, like many other distributors, outsources its billing and invoice processing to a third-party processor. NGEMC utilizes utilityPOWERnet from Southeastern Data Cooperative, a computerized Customer Information System, to maintain information for all billing, accounting, and payroll. All other accounting and finance responsibilities are handled by NGEMC's Board of Directors, President and Chief Executive Officer, and executive management team who provide oversight and perform the daily activities.

[1] This customer count excludes those customers who have Outdoor Lighting accounts with NGEMC as well as accounts for other services. At June 30, 2009, there were 19,849 of these customers. The kilowatt hours sold includes all kilowatt hours for all accounts; revenue also includes all accounts.

FINDINGS

Our review of NGEMC found issues involving customer classification that could impact (1) the proper reporting of electric sales and/or (2) nondiscrimination in providing power to members of the same rate class. In addition, we found, as of June 30, 2009, NGEMC's cash ratio was about 2 percent, which is less than TVA's established guidelines for adequate cash reserves of 5 to 8 percent. Finally, as we explain herein, we found certain opportunities to enhance TVA's oversight of the distributors.

PROPER REPORTING OF ELECTRIC SALES AND NONDISCRIMINATION IN PROVIDING POWER TO MEMBERS OF THE SAME RATE CLASS

As discussed below, we identified a customer classification issue that could impact (1) the proper reporting of electric sales and/or (2) the ability to ensure nondiscrimination in providing power to members of the same rate class.[2] We estimated the monetary effect of the classification issues and found the monetary effect would not be significant. However, there is a qualitative issue that is significant due to misclassifications resulting from an NGEMC policy. Correcting customer classification and metering issues is important to ensure all customers are placed in the correct rate classification and charged the same rate as other customers with similar circumstances.

Customer Classification Issues

Our review of customer classification at NGEMC identified 302 possible misclassifications. We provided a listing of these 302 accounts to NGEMC for further review, and they determined that 268 of these accounts were appropriately classified and noted 34 misclassified customer accounts. The 34 customer accounts were classified under the Residential Rate – Schedule RS,[3] although they should have been classified under the General Power Rate – Schedule GSA.[4] The GSA schedule is divided into three parts—Part 1, Part 2,

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[2] Section 5 Resale Rates subsection (a) of the power contract between TVA and the distributor states that "power purchased hereunder shall be sold and distributed to the ultimate consumer without discrimination among consumers of the same class and that no discriminatory rate, rebate, or other special concession will be made or given to any consumer, directly or indirectly."

[3] Under the Residential Rate – Schedule RS, customers are classified based on the following requirement: "This rate shall apply only to electric service to a single-family dwelling (including its appurtenances if served through the same meter), where the major use of electricity is for domestic purposes such as lighting, household appliances, and the personal comfort and convenience of those residing herein."

[4] Under the General Power Rate – Schedule GSA, customers are classified based on the following requirements:

- GSA Part 1 – If (a) the higher of (i) the customer's currently effective contract demand, if any, or (ii) its highest billing demand during the latest 12-month period is not more than 50 kW and (b) customer's monthly energy takings for any month during such period do not exceed 15,000 kWh.
- GSA Part 2 – If (a) the higher of (i) the customer's currently effective contract demand or (ii) its highest billing demand during the latest 12-month period is greater than 50 kW but not more than 1,000 kW or (b) the customer's billing demand is less than 50 kW and its energy takings for any month during such period exceed 15,000 kWh.
- GSA Part 3 – If the higher of (a) the customer's currently effective contract demand or (b) its highest billing demand during the latest 12-month period is greater than 1,000 kW.

and Part 3—based on electric usage and demand.[5] Specifically, we noted:

- Fifteen customer accounts were for services other than residential use, such as shops and garages.
- Nine customer accounts classified as residential were separately metered well pumps that served the residence according to NGEMC personnel.
- One customer account was a group home.
- Nine customer accounts were cabins owned by nonprofit organizations.

NGEMC personnel stated they reclassified the 15 customer accounts and one of the nine well pumps from residential to GSA in August 2010. We estimated the monetary effect of all the classification issues and found the monetary effect would not be significant.

While these misstatements are not significant from a quantitative standpoint, there are qualitative issues that are significant due to their systemic nature caused by NGEMC policies effective during the audit period. The identified misclassifications were found to be systemic in nature in the following two areas:

- NGEMC management stated it was their policy to allow accounts for separately metered well pumps to be classified as residential if the well pump only services a residence. However, according to the Residential Rate – Schedule RS, only service "to a single-family dwelling (including its appurtenances if served through the same meter)" qualifies for the residential rate; therefore, separately metered well pumps should be billed under a GSA rate.
- NGEMC management also stated that in prior years NGEMC consistently used the residential classification for any facility with living quarters—this would include group homes and cabins owned by individuals and/or organizations. NGEMC management stated this is no longer practiced, and they recognize these types of accounts should be classified as GSA. NGEMC is in the process of reviewing classification of these types of accounts to determine if changes are needed; however, as of November 3, 2010, no accounts had been reclassified. The Office of the Inspector General (OIG) concurs with these planned actions.

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[5] Demand is a measure of the rate at which energy is consumed. The demand an electric company must supply varies with the time of day, day of the week, and the time of year. Peak demand seldom occurs for more than a few hours or fractions of hours each month or year, but electric companies must maintain sufficient generating and transmission capacity to supply the peak demand. Demand charges represent the high costs electric companies pay for generating and transmission capacity that sits idle most of the time. Demand charges are based on the amount of energy consumed in a specified period of time known as a demand interval. Demand intervals are usually 15 or 30 minutes. (Engineering Tech Tips, December 2000, Dave Dieziger, Project Leader, United States Department of Agriculture Forest Service, Technology & Development Program, http://www.fs.fed.us/eng/pubs/htmlpubs/htm00712373/index.htm.)

For TVA distributors, the commercial and manufacturer Schedules of Rates and Charges direct that metered demand be calculated as "the highest average during any 30-consecutive-minute period of the month of the load metered in kW."

While our testing identified 19 instances where the well pump and group home and cabin policies resulted in a misclassified customer account, we do not know how many other such instances may exist. In addition, NGEMC has received a hydro credit on the Schedule 1 for each well pump, group home, and cabin incorrectly classified as residential. We estimated the monetary effect of the resulting unearned hydro credits and found the monetary effect would not be significant.

USE OF ELECTRIC SYSTEM REVENUES

Under Section 6 of the TVA power contract, "Use of Revenues," 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. As discussed below, we found NGEMC did not have enough cash on hand to provide a cash reserve within TVA's established guidelines for adequate cash reserves of 5 to 8 percent.[6]

As of June 30, 2009, NGEMC reported about $4.5 million in its cash and cash equivalent accounts. Table 2 shows NGEMC's cash ratio was about 2 percent. This amount is lower than TVA's established guidelines for adequate cash reserves of 5 to 8 percent.

NGEMC's Cash Accounts and Cash Ratio

	Cash and Cash Equivalents
FY 2009	$4,535,303
Cash Ratio	2.07%

Table 2

NGEMC funds its capital expenditures through use of the United States Department of Agriculture, Rural Utilities Services (RUS)[7] Electric Program, upon completion of capital projects. Table 3, as shown on the following page, shows information about major capital expenditure plans for FY 2010 obtained from NGEMC.

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6 TVA reviews the cash ratios of distributors as part of its regulatory rate review function. Cash ratio is calculated as follows:

$$\frac{\text{Cash + Cash Equivalents}}{\text{Total Variable Expenses (Operations and Maintenance + Purchased Power)}}$$

7 The United States Department of Agriculture, Rural Utilities Services Electric Program, provides leadership and capital to upgrade, expand, maintain, and replace America's rural electric infrastructure. Under the authority of the Rural Electrification Act of 1936, the Electric Programs make direct loans and loan guarantees to electric utilities to serve customers in rural areas.

NGEMC's FY 2010 Planned Capital Expenditures

Capital Expenditure Plans	Project Cost
New Underground Service	$2,577,916
New Overhead Service	1,225,901
Line Conversion/Changes	4,725,499
New Substations	2,722,989
Substation and Meter Point Changes	2,040,629
Transformer and Meters	1,411,410
Sets of Service Wire	2,041
Sectionalizing	168,880
Capacitors	11,397
Ordinary Replacements (poles)	5,114,183
Security Lights	358,548
Supervisory Control and Data Acquisition	77,174
Total Planned Capital Expenditures	**$20,436,567**

Table 3

Although planned expenditures for FY 2010 were approximately $20 million, NGEMC's actual capital expenditures in FY 2010 totaled approximately $12.2 million, and NGEMC obtained about $12 million in loans from RUS. Because of the method NGEMC has selected for funding its capital improvements, these items have limited impact on NGEMC's ongoing cash position.

According to TVA records, over the past five years, NGEMC was approved for rate increases in October 2005, 2006, and 2008 and in January 2008. Table 4 shows the rate increases received by NGEMC and the cash position and cash ratio at June 30 prior to the effective date of each rate increase.

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

Cash on Hand Equivalent to an 8% Cash Ratio	Cash and Cash Equivalents as Reported and Cash Ratio	Rate Increase[8]		
		Additional Revenue	Percent	Effective Date
$11,924,348	$1,610,464 (CR = 1.08%)	$5,115,957	3.28%	10/1/2005
$14,105,327	$3,462,085 (CR = 1.96%)	$2,000,000	1.26%	10/1/2006
$14,853,782	$10,055,351 (CR = 5.42%)	$281,846	0.14%	1/1/2008
$15,427,974	$6,117,539 (CR= 3.17%)	$958,231	0.48%	10/1/2008

Table 4

8 These are the rate increases requested by and approved for the distributor. These increases do not include any rate increases or decreases made by TVA, including fuel cost adjustments, which were passed through by the distributor to the customer.

Discussions with NGEMC management indicated their operating philosophy was to manage debt through borrowing and open loans with RUS. NGEMC establishes a workplan for work anticipated over the next four years and requests loan packages based on that workplan. Depending on allocations made to the program by Congress, the money may or may not be available. When the funds are allocated or approved by the government, then the funds become available for NGEMC to draw upon.

TVA OVERSIGHT OPPORTUNITIES

We found opportunities to enhance TVA's oversight of this distributor; however, the issues noted for this distributor were the same as those reported in previous OIG distributor reports. Specifically, we noted TVA has not:

- Provided definitive guidance for distributors on what constitutes prudent expenditures.
- Adequately defined the process for granting the Small Manufacturer Credit to ensure proper documentation, including evidence of approval, is submitted and maintained.

In response to the previous reports, TVA agreed to take corrective actions on these issues. Full discussion of these issues and TVA's planned actions can be found in prior OIG distributor reports on our Web site, www.oig.tva.gov.

RECOMMENDATIONS

We recommend the Group President, Strategy and External Relations, work with NGEMC to improve compliance with the contract and/or strengthen internal controls. Specifically, NGEMC should:

1. Implement procedures to assist in identifying accounts that need to be reclassified as commercial when service starts or changes to a nonresidential type (i.e., business or separately metered structure).

   NGEMC's Response – NGEMC agreed with the recommendation and stated accounts identified during the OIG audit were in the process of being reclassified to the recommended rate/class. In addition, management stated policies and procedures were in place to address the proper classification of accounts when service begins to ensure compliance with proper rate/class. NGEMC is exploring steps to allow for review of existing accounts to determine proper classification in the event that a former residence is repurposed as a nonresidential facility without notification to the co-op. NGEMC is making classification changes to accounts identified during the OIG audit and plans to have them completed on or before September 2011. See Appendix B for NGEMC's complete response.

TVA Management's Comments – TVA agreed electric service should be provided in accordance with the availability provisions of the applicable rate schedules. The target completion date for this is September 2011. See Appendix C for TVA's complete response.

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

2. Modify the policy classifying well pumps serving residences as residential accounts and classify these accounts as GSA.

   NGEMC's Response – NGEMC agreed with the recommendation and stated the policy of classifying well pumps as residential accounts had been changed as of completion of the audit. NGEMC stated all new accounts of this type are being and will continue to be classified as a GSA account. The effective date of this change was December 1, 2010. See Appendix B for NGEMC's complete response.

   TVA Management's Comments – TVA management agreed the distributor's customer rate classification policy should be consistent with the rate schedules. The policy of classifying well pumps as residential accounts had been changed as of completion of this audit. All new accounts of this type are being and will continue to be classified as a GSA account. The effective date of this change is December 1, 2010. See Appendix C for TVA's complete response.

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

3. Modify the rate classes of the customer accounts from residential to GSA for the identified separately metered well pumps.

   NGEMC's Response – NGEMC agreed with the recommendation and stated accounts identified during the OIG audit were in the process of being reclassified to the proper rate/class. NGEMC further stated review of residential class customers to identify and reclassify separately metered well pumps will be conducted in the coming months with a targeted completion date of December 2011.

   TVA Management's Comments – TVA management agreed customer rate classification should comply with the applicable rate schedule. TVA management also stated the distributor was in the process of reclassifying accounts to the correct rate and class. The planned completion date is December 2011. See Appendix C for TVA's complete response.

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

OBJECTIVE, SCOPE, AND METHODOLOGY

This audit was initiated as a part of our annual workplan. The objective was to determine compliance with key provisions of the power contract between the Tennessee Valley Authority (TVA) and North Georgia Electric Membership Corporation (NGEMC) including:

- Proper reporting of electric sales by customer class to facilitate proper revenue recognition and billing by TVA.
- Nondiscrimination in providing power 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
  - Reasonable reserves for renewals, replacements, and contingencies

To achieve our objective, we:

- Obtained electronic billing data for the audit period. To validate the reliability of the billing data, we compared the data to the information reported to TVA on the Schedule 1. No significant differences were noted; therefore, the data was deemed reliable.
- Performed queries on data to identify classification, metering, and contract compliance issues. We reviewed results of the queries and selected accounts using nonstatistical sampling for further analysis and follow-up to determine whether misclassification, metering issues, or noncompliance with contract requirements occurred. Since nonstatistical sampling was used, projection of the results was not appropriate.
- Limited our work on internal controls to those control deficiencies identified as contributing to noted instances of noncompliance with the power contract and/or the TVA Act.
- Determined through inquiry and review of documentation whether NGEMC had any nonelectric, system-related business interests supported by electric system funds.
- Obtained disbursements listings for the audit period. We reviewed and analyzed disbursements to identify instances where electric system funds may have been used for purposes not allowed under the TVA power contract. We used nonstatistical sampling to select questionable disbursements for further analysis and follow-up. Since nonstatistical sampling was used, projection of the results was not appropriate.
- Reviewed cash and cash equivalents in relation to planned capital expenditures and other business uses of cash.

OBJECTIVE, SCOPE, AND METHODOLOGY (cont.)

When evaluating results of our audit work, we used both qualitative and quantitative factors when considering the significance of an item. For the purposes of this audit, the quantitative factor considered in determining an item's significance is whether the item exceeds 3 percent of the average annual purchased power from TVA for the audit period. For this audit, this amount equaled $5,408,950. Also for the purposes of this audit, we considered any errors identified as systemic or intentional as significant.

The scope of the review was for the period July 2007 through June 2009. Fieldwork was conducted May 2010 through July 2010 and included visiting NGMEC's offices in Dalton, Georgia. 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.

North Georgia Electric Membership Corporation

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December 21, 2010

Mr. Robert E. Martin, Assistant Inspector General (Audits and Inspections)
Office of the Inspector General
Tennessee Valley Authority
400 West Summit Hill Drive
Knoxville, TN 37902-1401

RESPONSE TO REQUEST FOR COMMENTS – DRAFT AUDIT 2010-13025 – DISTRIBUTOR REVIEW OF NORTH GEORGIA ELECTRIC MEMBERSHIP CORPORATION

Dear Mr. Martin:

The following is management's response to the specific findings in the Distributor Review of North Georgia Electric Membership Corporation. 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 recommendations.

1. ***Implement procedures to assist in identifying accounts that need to be reclassified as commercial when service starts or changes to a nonresidential type (i.e., business or separately metered structure).***
   Response: NGEMC agrees with recommendation. Accounts identified during the OIG audit are in the process of being reclassified to the recommended rate/class. Policies and procedures are in place as a result of SAS70 compliance that address the proper classification of accounts when service begins to ensure compliance with proper rate/class. Steps are being explored to allow for review of existing accounts to determine proper classification in the event that a former residence is repurposed as a nonresidential facility without notification to the co-op. Classification changes to accounts identified during the OIG audit will be completed on or before September, 2011.

2. ***Modify the policy classifying well pumps serving residences as residential accounts and classify these accounts as GSA.***
   Response: NGEMC agrees with the recommendation. The policy of classifying well pumps as residential accounts has been changed as of completion of the audit. All new accounts of this type are being and will continue to be classified as a GSA account. The effective date of this change is December 1, 2010.

3. ***Modify the rate classes of the customer accounts from residential to GSA for the identified separately metered well pumps.***
   Response: NGEMC agrees with the recommendation. Accounts identified during the OIG audit are in the process of being reclassified to the proper rate/class. Further review of residential class customers to identify and reclassify separately metered well pumps will be conducted in the coming months with a targeted completion date of December, 2011.

We appreciate the courtesies and professionalism of your staff during the audit. If additional information is needed, please contact our staff.

Sincerely,
NORTH GEORGIA ELECTRIC MEMBERSHIP CORPORATION

Kathryn D West

Kathryn D. West
Executive Vice President and CFO

North Georgia E.M.C.

December 21, 2010

Robert E. Martin, ET 3C-K

RESPONSE TO DRAFT INSPECTION REPORT 2010-3025 – DISTRIBUTOR REVIEW OF NORTH GEORGIA ELECTRIC MEMBERSHIP CORPORATION

This is in response to your memorandum dated December 7, 2010.

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 recommendations.

1. Implement procedures to assist in identifying accounts that need to be reclassified as commercial when service starts or changes to a nonresidential type (i.e., business or separately metered structure).

   - TVA management agrees that electric service should be provided in accordance with the availability provisions of the applicable rate schedule.
   - **Actions taken or planned, and completion dates:** The distributor is planning to work with their billing service provider to resolve these classification issues. The planned completion date is September 2011.

2. Modify the policy classifying well pumps serving residences as residential accounts and classify these accounts as GSA.

   - TVA management agrees that the distributor's customer rate classification policy should to be consistent with the rate schedules.
   - **Actions taken or planned, and completion dates:** The policy of classifying well pumps as residential accounts has been changed as of completion of this audit. All new accounts of this type are being and will continue to be classified as a GSA account. The effective date of this change is December 1, 2010.

3. Modify the rate classes of the customer accounts from residential to GSA for the identified separately metered well pumps.

   - TVA management agrees that customer rate classification should comply with the applicable rate schedule.

- **Actions taken or planned, and completion dates:** The distributor is in the process of reclassifying accounts to the correct rate and class. The planned completion date is December 2011.

John G. Trawick
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