



Memorandum from the Office of the Inspector General

November 16, 2011

Kimberly S. Greene, WT 7B-K
Ronald L. Owens, SP 3A-C

**REQUEST FOR FINAL ACTION – AUDIT 2010-13285 – DISTRIBUTOR AUDIT OF
VOLUNTEER ENERGY COOPERATIVE**

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 me or Richard C. Underwood, Director, Corporate Governance and Finance Audits, at (423) 785-4824. We appreciate the courtesy and cooperation received from your staff during the audit.

David P. Wheeler
Deputy Assistant Inspector General
(Audits)
ET 3C-K

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Attachment
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OIG File No. 2010-13285



Office of the Inspector General

Audit Report

To the Group President, Strategy
and External Relations, and to the
Vice President, Retail Regulatory
Affairs

DISTRIBUTOR AUDIT OF VOLUNTEER ENERGY COOPERATIVE

Audit Team

Jessica L. Monroe
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Audit 2010-13285
November 16, 2011

ACRONYMS AND ABBREVIATIONS

EGC	Enhanced Growth Credit
FCA	Fuel Cost Adjustment
FY	Fiscal Year
kW	Kilowatt
kWh	Kilowatt Hours
NISC	National Information Solutions Cooperative
OIG	Office of the Inspector General
TVA	Tennessee Valley Authority
USDA	United States Department of Agriculture

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- A. OBJECTIVE, SCOPE, AND METHODOLOGY
- B. LETTER DATED OCTOBER 25, 2011, FROM RODY BLEVINS TO
ROBERT MARTIN
- C. MEMORANDUM DATED OCTOBER 31, 2011, FROM KIMBERLY S.
GREENE TO ROBERT E. MARTIN



Audit 2010-13285 – Distributor Audit of the Volunteer Energy Cooperative

EXECUTIVE SUMMARY

Why the OIG Did This Audit

As part of our annual audit plan, the OIG (Office of the Inspector General) performed an audit of the electric system of Volunteer Energy Cooperative, a distributor based in Decatur, Tennessee. The objective of the audit was to determine compliance with provisions of the power contract between the Tennessee Valley Authority (TVA) and Volunteer for the audit period July 2008 through June 2010. Key contract provisions included (1) proper reporting of electric sales, (2) nondiscrimination in providing power, and (3) use of electric revenue for approved purposes. For fiscal year (FY) 2010, Volunteer provided power to approximately 110,000 customers resulting in electric sales revenue of approximately \$200 million. During the audit period, Volunteer also operated a natural gas division and a wholly owned propane subsidiary. At June 30, 2010, Volunteer had a 3.52 percent cash ratio before considering planned FY 2011 capital expenditures and a negative 2.09 percent cash ratio after considering planned FY 2011 capital expenditures.

What the OIG Found

Volunteer generally complies with the contract provisions for (1) proper reporting of electric sales and (2) nondiscrimination in providing power. However, we noted instances of noncompliance with other provisions of the power contract. The most important instances were related to use of electric system revenues and customer classification. In relation to use of electric system revenues, Volunteer:

- Pledged electric funds to guarantee United States Department of Agriculture Rural Development (Rural Development) loans to customers.
- Leased-to-own diesel generators on behalf of a customer.
- Used electric funds to pay operating expenses of nonelectric businesses.
- Invested electric funds in a nonelectric business.
- Pledged electric funds to guarantee loans for nonelectric businesses.

We estimate the total electric funds at risk at June 30, 2010, due to the above uses of electric system revenue, to be approximately \$2.7 million. These risks have the potential to reduce the cash ratio from 3.52 percent before planned FY 2011 capital expenditures to 2.03 percent.

In the areas of customer classification and metering, Volunteer:

- Incorrectly classified approximately 8 percent of commercial accounts identified for follow-up review as residential.
- Did not use contract demand to classify General Power Rate – Schedule GSA customers.



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- Did not follow TVA guidance requiring documentation and maintenance of an evaluation explaining why a demand meter was not needed for customer accounts with usage exceeding 25,000 kilowatt hours.

The second issue was the result of a conscious decision made by Volunteer management not to follow provisions of the power contract. We were unable to estimate the monetary effect of all the issues we identified because in some instances information was not available. However, for those instances where information was available, the monetary impact would not be significant to Volunteer or TVA.

Other areas for improvement in contract compliance were noted regarding calculation of customer bills and financial reporting to TVA. Specifically, we found:

- Time frames during the audit period where rates used to calculate customer bills did not match TVA approved retail rates (incorrect Fuel Cost Adjustments for 3 months, GSA Part 3 demand charges for 9 months, and Outdoor Lighting customer charges for 24 months).
- Enhanced Growth Credit was incorrectly calculated for two customers.
- Calculation of the minimum bill amount for GSA customers differed from the minimum bill provision in the power contract.
- Billing system programming for GSA customer minimum bill calculation differed from the power contract minimum bill provision, and the calculation we were told was in use by Volunteer's President.
- Excess demand charges were not automatically calculated in the billing system for GSA customers.
- Allocations between electric and nonelectric businesses were not approved by TVA and did not consider all shared costs and expenses.

Volunteer's internal controls could be strengthened in relation to (1) the due diligence in lending process, (2) customer contract maintenance, (3) customer identification on contract documentation, and (4) accuracy of contract demand in the billing system.

We also identified three areas where TVA's oversight of distributors could be enhanced. Two areas identified are new oversight issues addressing the lack of (1) guidance related to the due diligence process for cooperatives providing loans to customers from funds provided by Rural Development and (2) review of cooperative distributors' capital credit allocations in the retail rate setting process. The remaining issue, regarding the lack of a current joint cost study, has been reported in previous OIG distributor audit reports, and TVA has agreed to take corrective action on this issue.



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What the OIG Recommends

We make 18 specific recommendations in this report related to Volunteer and recommend the Group President, Strategy and External Relations, work with Volunteer to resolve them. The recommendations generally relate to (1) complying with power contract provisions, (2) remediating classification and metering issues, and (3) strengthening internal controls.

We also make three recommendations specific to TVA. Generally those recommendations are that the Group President, Strategy and External Relations, should (1) discontinue allowing distributors to pledge electric system funds as guarantees for customer loans with Rural Development or modify the power contract appropriately, (2) develop and provide guidance to distributors defining a proper due diligence process when loaning Rural Development funds to customers for economic development, and (3) consider capital credit allocations in the retail rate setting and approval process.

Volunteer and TVA Management's Comments

With regard to the 18 specific recommendations related to Volunteer:

- Volunteer disagreed with 3 of the 18 recommendations including those related to (1) the practice of pledging electric funds to guarantee Rural Development loans to customers, (2) the leasing of diesel generators to customers, and (3) a more comprehensive due diligence in lending process. Volunteer agreed to take action on the remaining 15 recommendations.
- TVA management agreed with all of our recommendations but stated they plan to investigate further the finding regarding the leasing of diesel generators to customers.

In regard to the recommendations that are specific to TVA, TVA management stated (1) they plan to recommend formal approval by the TVA Board of a Use of Revenues policy that expressly approves distributor participation in the United States Department of Agriculture's Rural Economic Development Loan and Grant Program, and (2) consideration of Volunteer's capital credit allocations is inherent in TVA's revised retail ratemaking and approval process.

See Appendix B for Volunteer's complete response and Appendix C for TVA's complete response.

Auditor's Response

Volunteer did not provide any additional information regarding the three recommendations it disagreed with to cause us to change our recommendations. We concur with the actions taken and/or planned to be taken by TVA in regard to our recommendations.

BACKGROUND

Volunteer Energy Cooperative is a distributor for Tennessee Valley Authority (TVA) power based in Decatur, Tennessee, with revenues from electric sales of approximately \$200 million in fiscal year (FY) 2010. Prior to April 1, 2011,¹ TVA relied 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 Volunteer as of June 2010.

Volunteer's Customer Mix as of June 2010

Customer Classification	Number of Customers	Revenue	Kilowatt Hours Sold
Residential	93,624	\$132,733,037	1,459,542,347
General Power – 50 Kilowatt (kW) and Under (Commercial)	15,354	19,216,270	180,001,111
General Power – Over 50 kW (Commercial or Manufacturing)	849	44,296,524	561,375,355
Street and Athletic	87	700,716	5,780,512
Outdoor Lighting ²	382	2,718,064	26,564,036
Total	110,296	\$199,664,611	2,233,263,361

Table 1

TVA's distributors are required to establish control processes over customer setup, rate application, and measurement of usage to ensure accurate and complete reporting to TVA. Volunteer, like many other distributors, outsources its billing and invoice processing to a third-party processor, National Information Solutions Cooperative (NISC). Volunteer uses NISC systems to establish and set up new customers, input customer meter information, perform the monthly billing process, and maintain customer account information. Additionally, NISC provides Volunteer with management reporting capabilities (e.g., exception reports) designed to ensure the accuracy and completeness of the customer invoice and Schedule 1 provided to TVA. All other accounting and finance responsibilities are handled by Volunteer, which has a Board of Directors who provide oversight and a President and management team who manage the daily activities.

¹ On April 1, 2011, TVA moved from distributors self-reporting customer usage to billing distributors based on actual energy and demand takings using meter readings from the wholesale delivery points.

² The "Number of Customers" represents those customers who only have Outdoor Lighting accounts with Volunteer at June 30, 2010. In addition, another 27,801 customers had Outdoor Lighting accounts as well as accounts for other services. However, the totals for "Revenue" and "Kilowatt Hours Sold" include both categories of Outdoor Lighting customers.

During the audit period, Volunteer also operated a natural gas division and a wholly owned propane subsidiary.

As of June 30, 2010, Volunteer had a 3.52 percent cash ratio before considering planned FY 2011 capital expenditures³ and a negative 2.09 percent cash ratio after considering planned FY 2011 capital expenditures, which is below TVA's established guidelines for an adequate cash ratio of 5 to 8 percent.⁴ Specifically, Volunteer had \$6,308,839 in cash and cash equivalents and \$10,052,125 in planned capital projects for FY 2011 that would result in a negative \$3,743,206 cash balance (see Table 2 below).

Volunteer's Cash Accounts Compared to Planned Capital Expenditures

	Cash and Cash Equivalents at June 30, 2010	FY 2011 Planned Capital Expenditures	Reserve After Planned Capital Expenditures
Amount	\$6,308,839	\$10,052,125	(\$3,743,206)
Cash Ratio Percentage	3.52%		(2.09)%

Table 2

According to TVA records, as of our audit period, Volunteer was approved for rate increases in 2005, 2006, and 2007. Table 3 shows the rate increases received by Volunteer and the cash position and cash ratio at June 30 prior to the effective date of the rate change.

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

Cash on Hand Equivalent to an 8% Cash Ratio	Cash and Cash Equivalents ⁵ and Cash Ratio	Rate Increase ⁶		
		Change in Revenue	Percent	Effective Date
\$11,628,673	\$3,366,157 (CR = 2.32%)	\$6,721,467	4.89%	10/01/2005
\$12,490,818	\$1,679,054 (CR=1.08%)	\$921,460	0.67%	10/01/2006
\$13,035,664	\$4,346,722 (CR=2.67%)	\$2,098,945	1.19%	10/01/2007

Table 3

³ Volunteer planned \$12,052,125 in capital expenditures for FY 2011 with the intent to pay for these expenditures from cash reserves; however, as of April 2011, Volunteer had used \$2 million in Rural Utilities Service loans to finance capital expenditures. We removed the \$2 million financed through RUS from our cash ratio analysis.

⁴ TVA reviews the cash ratios of distributors as part of its regulatory rate review function. Cash ratio is calculated as follows:
$$\frac{\text{Cash} + \text{Cash Equivalents}}{\text{Total Variable Expenses (Operations and Maintenance + Purchased Power)}}$$

⁵ The cash and cash equivalents and cash ratio were computed based on information from Volunteer's annual report as of June 30 prior to the effective date of the rate increase.

⁶ These are the rate increases enacted by 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 Volunteer management indicated its operating philosophy is generally conservative. Volunteer prefers to keep a low debt to cash ratio, but management is comfortable entering into debt through Rural Utilities Services loans, where appropriate. Volunteer's goal is to maintain cash on hand equivalent to 1 month's power bill.

FINDINGS

Volunteer generally complies with the contract provisions for (1) proper reporting of electric sales and (2) nondiscrimination in providing power. However, we noted instances of noncompliance with other provisions of the power contract. The most important instances were related to use of electric system revenues and customer classification. In relation to the use of electric system revenues, Volunteer (1) pledged electric funds to guarantee United States Department of Agriculture Rural Development⁷ (Rural Development) loans to customers, (2) leased-to-own diesel generators on behalf of a customer, (3) used electric funds to pay operating expenses of nonelectric businesses, (4) invested electric funds in nonelectric businesses, and (5) pledged electric funds to guarantee loans for nonelectric businesses. In the area of customer classification, Volunteer (1) incorrectly classified approximately 8 percent of commercial accounts identified for follow-up review as residential, (2) did not use contract demand⁸ to classify General Power Rate – Schedule GSA customers, and (3) did not follow TVA guidance requiring documentation and maintenance of an evaluation explaining why a demand meter was not needed for customer accounts with usage exceeding 25,000 kilowatt hours (kWh). Other areas for improvement in contract compliance were noted regarding calculation of customer bills and financial reporting to TVA. We also identified areas where internal controls could be strengthened.

Finally, we identified three areas where TVA's oversight of distributors could be enhanced. Two areas identified are new oversight issues, and the remaining issue has been reported in previous Office of the Inspector General (OIG) distributor audit reports. TVA has agreed to take corrective action on this issue.

⁷ Rural Development is a division of the United States Department of Agriculture that administers the Rural Economic Development Loan and Grant Program.

⁸ 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 Diezinger, 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."

EXPENDITURES OF ELECTRIC SYSTEM REVENUES DID NOT COMPLY WITH POWER CONTRACT

We found Volunteer (1) pledged approximately \$1.3 million of electric funds to guarantee Rural Development loans to customers, (2) used approximately \$347,000 of electric funds to lease-to-own diesel generators on behalf of a customer, (3) used approximately \$339,000 of electric funds to pay operating expenses of nonelectric businesses, (4) invested approximately \$36,870 of electric funds in a nonelectric business, and (5) pledged \$700,000 of electric funds to guarantee loans for nonelectric businesses. These uses of electric funds fall outside the allowed uses under the power contract provisions discussed below. We estimate the total electric funds at risk⁹ at June 30, 2010, to be \$2,672,976, which would reduce the cash ratio from 3.52 percent before planned FY 2011 capital expenditures to 2.03 percent.

Section 6 of the power contract, "Use of Revenues," defines approved uses of revenues from electric system operations, including any surplus, as: (1) operating expenses, (2) debt service, (3) reasonable reserves for renewals, replacements, and contingencies and cash working capital adequate to cover operating expenses for a reasonable number of weeks, and (4) new electric system construction or the retirement of debt prior to maturity. In addition, Section 1(a) of the power contract, "Schedule of Terms and Conditions," prohibits furnishing, advancing, pledging, lending, or otherwise diverting electric system funds and revenues to nonelectric purposes.

Electric Funds Pledged to Guarantee Rural Development Financing to Customers

At June 30, 2010, Volunteer had pledged approximately \$1.3 million in electric system funds to guarantee Rural Development financing to customers. This amount included approximately \$1.1 million that Volunteer is currently repaying to Rural Development on behalf of one customer who defaulted on two intermediary loans in November 2008 and approximately \$188,000 for grant funds loaned to customers.

Volunteer uses Rural Development to provide economic development loan funds to customers in its service area. Rural Development provides intermediary loans and grants to Volunteer as economic development funds. Intermediary loans are funded by Rural Development and loaned to Volunteer who then reloans the funds to a customer. To obtain an intermediary loan, a customer must apply for the loan with Rural Development by answering a series of questions, such as how many jobs will be created, location of the project, unemployment rate of the location, etc. Rural Development then evaluates the application by assigning points to the customer's answers. If the total points assigned to the application exceed the Rural Development threshold for lending, the customer is approved for

⁹ We consider electric funds at risk to be revenues of the electric system that are or could be diverted for nonelectric purposes in violation of the power contract.

the loan, and the funds are dispersed to the intermediary. The intermediary, in this case Volunteer, guarantees the loans by accepting the loan funds and then reloaning the funds to the customer.

In addition to the Rural Development intermediary loan program, Volunteer receives economic development funds through Rural Development grant programs. The grant programs distribute a set amount of money to a distributor who then loans the money to customers in the service area for economic development. As the customers repay the loaned amounts, new loans to other customers are made to continue using the grant funds for economic development. Volunteer currently has approximately \$188,000 in grant funds loaned to customers for economic development purposes. Rural Development does not require the grant funds to be repaid until the distributor no longer operates an economic development program. In the event a customer defaults on a loan using grant funds, the distributor would be responsible to repay the outstanding obligation if Rural Development determines the distributor had not performed adequate due diligence. Rural Development does not determine the adequacy of the distributors' due diligence until a customer defaults on loaned grant funds. Until Rural Development determines differently, we consider Volunteer to have pledged electric system funds to guarantee all outstanding loans made from grant funds. For more information, see further discussion on the due diligence process later in the report.

As stated above, Section 1(a) of the power contract, "Schedule of Terms and Conditions," prohibits pledging electric funds to guarantee loans for other distributor operations, and no other section of the power contract specifically allows electric system funds to be used for economic development projects. There is a significant risk a court would find the pledging of electric funds to guarantee loans for customers is not permitted under the contract because (1) the power contract prohibits pledging electric funds to guarantee loans to nonelectric operations and (2) there is no specific language in the power contract allowing electric system funds to be used for economic development projects. However, according to TVA management it is a common practice for cooperatives to use electric system funds to guarantee Rural Development financing for customers. In addition, during another OIG distributor review, we noted a distributor contract with TVA that included a section outlining TVA approval of a set amount of the electric system's funds that could be used each year to loan electric system funds to customers for economic development projects.

Electric Funds Used to Purchase Generators for Customer

We found Volunteer used approximately \$347,000 in electric funds for lease payments and operating costs associated with maintaining generators at a customer location. In September 2003, Volunteer entered into an agreement to lease-to-own four (two megawatt) diesel generators. These generators were installed at a customer's location, and Volunteer subleased the generators to this customer with an option to purchase.

As stated above, Section 6 of the power contract allows a distributor to use electric revenues for certain purposes for the benefit of the electric system. The use of electric funds related to the generators is not provided for under Section 6 of the power contract.

Volunteer's agreement with the customer required a monthly payment of \$29,300, which included Volunteer's lease obligation¹⁰ and executory costs. Volunteer reduced the customer's lease payment at the customer's request from \$29,300 to \$10,000 per month from January 2009 through the end of our audit period at June 2010, resulting in approximately \$347,000 of unrecovered costs incurred by Volunteer for the lease, operation, and maintenance of the generators during the audit period. Volunteer personnel stated the agreement with the customer was designed for Volunteer to break even. According to Volunteer personnel, the customer requested the lowered payment due to economic hardship, and Volunteer would eventually recover the difference by extending the customer's lease. Volunteer provided an agreement dated January 2009 to lower the monthly payment to \$10,000 through July 2009 and extend the lease term to compensate for the six months of lowered payments. We were provided no other documentation of amended lease agreements with the customer showing lowered payments between August 2009 and June 2010 or subsequent extensions of the lease term. The lease payment was still \$10,000 per month when we concluded our site visit in June 2011.

Electric Funds Used to Subsidize Operating Expenses of Nonelectric Businesses

We found at June 30, 2010, Volunteer had paid approximately \$339,000 in operating expenses during the audit period on behalf of the natural gas division. The natural gas division operated at a loss in both FYs 2009 and 2010. According to Volunteer personnel, the natural gas division operated at a loss for years. During this period the electric system covered operating obligations, including loan and line of credit payments and recorded the amounts as a receivable from the natural gas division. Currently, the natural gas division is still operating at a loss and unable to repay Volunteer for expenses paid on its behalf during the audit period.

TVA has allowed distributors to invest portions of their reasonable reserves in other operations with TVA approval; however, we could find no evidence of a loan between the electric system and natural gas division or TVA approval of Volunteer's investment of its reasonable reserves to pay for operating obligations of nonelectric businesses.

¹⁰ Volunteer entered into a lease-to-own agreement with a lending company for the four generators on behalf of the customer. Volunteer's lease will expire in 2018 with the option to purchase the generators at that time. Volunteer's monthly lease obligation is \$17,580.45.

Electric Funds Invested in a Nonelectric Business

We found at June 30, 2010, Volunteer had invested approximately \$36,870 in the nonelectric propane business. Volunteer currently operates a wholly owned propane subsidiary and initially invested approximately \$36,870 in the propane company.

TVA has allowed distributors to invest their reasonable reserves in other operations with TVA approval; however, we could find no evidence of TVA approval of Volunteer's investments in its nonelectric businesses.

Electric Funds Pledged to Guarantee Loans for Nonelectric Businesses

Volunteer guaranteed \$700,000 of financing for its propane and natural gas businesses as of June 30, 2010. Volunteer guaranteed a \$450,000 loan for the propane business and a \$250,000 line of credit for the natural gas division. In the event the propane or natural gas businesses default on the financing arrangement, the lending company can require Volunteer to repay the outstanding balance.

As stated above, Section 1(a) of the power contract, "Schedule of Terms and Conditions," prohibits pledging electric funds to guarantee loans for other distributor operations.

Total Electric Funds at Risk and Impact on the Cash Ratio

We found the total electric funds at risk described above were \$2,672,976, which reduced the cash ratio from 3.52 percent before planned FY 2011 capital expenditures to 2.03 percent. This indicates that, in the absence of any additional capital improvements to the electric system or any unforeseen circumstance, if the distributor were required to satisfy all of the debts it has guaranteed and was unable to recoup all funds invested, its cash position would result in a cash ratio of 2.03 percent, which is below TVA's established guidelines for adequate cash reserves.

IMPROPER REPORTING OF ELECTRIC SALES AND/OR POTENTIAL DISCRIMINATION IN PROVIDING POWER TO CUSTOMERS

During our review of Volunteer's billing data, we identified two customer classification issues and one metering issue that could impact the (1) proper reporting of electric sales and/or (2) ability to ensure nondiscrimination in providing power to members of the same rate class.¹¹ The issues identified were (1) customer accounts incorrectly classified as residential, (2) not using contract demand to classify General Power Rate – Schedule GSA customers, and (3) not documenting and maintaining records of evaluations explaining why a demand meter was not installed for customer accounts with usage exceeding the

¹¹ Section 5 Resale Rates subsection (a) of the power contract between TVA and Volunteer dated September 15, 1975, states "...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."

recommended 25,000 kWh. The second issue above was the result of a conscious decision by Volunteer management not to follow provisions of the power contract. We were unable to estimate the monetary effect of all the issues we identified because in some instances information was not available. However, for those instances where estimates were made, the monetary effect on Volunteer and TVA would not be significant. Correcting 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 Accounts Misclassified as Residential

We found a total of 456 customer accounts misclassified under the Residential Rate – Schedule RS¹² that should have been classified under the General Power Rate – Schedule GSA.¹³ The GSA schedule is divided into three parts—Part 1, Part 2, and Part 3—based on electric usage and demand. We noted 5,711 customer accounts that appeared to be improperly classified based on customer name and/or the existence of multiple accounts at the same address. We requested Volunteer review these accounts. They determined 456 customer accounts (7.98 percent) were incorrectly classified. The monetary impact of the classification issues detailed below would not be significant to Volunteer or TVA. Specifically, we noted:

- 247 customer accounts were separately metered structures, such as a barn, garage, well, pump, etc., at residential locations. Schedule RS applies "only to electric service to a single-family dwelling." Because a well pump is not a single-family dwelling, the pump does not qualify for the residential rate.
- 208 customer accounts were commercial businesses.
- 1 customer account was lighting to a railroad crossing signal.

According to Volunteer personnel, all 456 customer accounts were reclassified from residential to the appropriate part of the GSA schedule based on the customer's energy and demand takings. Volunteer did not provide a response for 1,166 of the 5,711 customer accounts (20.42 percent) that appeared to be improperly classified.

¹² 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."

¹³ 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 kilowatts (kW) and (b) the customer's monthly energy takings for any month during such period do not exceed 15,000 kilowatt hours (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.

Customer Accounts Misclassified Between Parts of the GSA Schedule

According to Volunteer personnel, Volunteer management decided not to follow provisions of the GSA schedule that require customers to be classified based on contract demand, rather, they classified customer accounts using actual demand. We reviewed all customer accounts with contract demand values in the billing system and found 3 of the 16 (18.75 percent) customer accounts identified were misclassified between the three parts of the GSA schedule. Specifically, we found:

- 2 customer accounts should have been classified as GSA Part 3 rather than GSA Part 1 or Part 2 based on contract demand.
- 1 customer account should have been classified as GSA Part 2 rather than GSA Part 1 based on contract demand.

The GSA schedule classifies customers within the three parts of the schedule based on the higher of (1) currently effective contract demand or (2) the highest billing demand in the last 12 months. Volunteer's policy was to not enter contract demand values for GSA customers in the billing system. According to Volunteer personnel, in April 2011, Volunteer began entering contract demand in the billing system for all new GSA customers with a contract. However, Volunteer has not entered contract demand in the billing system for existing GSA customers with a contract established prior to April 2011. Without a contract demand value entered, GSA customers with a contract are classified based on actual demand takings. We estimated the effect of these misclassifications, and they were not significant to Volunteer or TVA.

Metering Issue

In addition to the customer classification issues, our review of billing agency data noted one issue related to metering of customers at Volunteer. Specifically, we found 34 customer accounts classified as GSA Part 2 that had energy usage in excess of 25,000 kWh but were not measured for demand.¹⁴ According to Volunteer management, customer accounts are evaluated for a demand meter once the account reaches 20,000 kWh; however, the practice is informal and no documentation of the evaluations was provided by Volunteer. Under Part 2 of the GSA schedule and the Wholesale Power Rate – Schedule WS with TVA, there would be no effect on the revenues for TVA or the distributor unless the customer demand exceeded 50 kW. Without demand meters in place or evidence indicating other circumstances exist that would prevent a customer from exceeding demand of 50 kW, we could not determine if these 34 customers would have exceeded 50 kW; therefore, we were unable to estimate the monetary effect.

¹⁴ In February 2010, in response to a finding in a previous OIG distributor audit report, TVA issued guidance to distributors in Tennessee on how to evaluate whether a demand meter is needed when a customer's usage reaches 25,000 kWh.

OTHER ISSUES

We identified ten additional areas where Volunteer (1) was not meeting power contract requirements with TVA or (2) could strengthen its internal controls. Other power contract compliance issues identified were: (1) some retail rates in the billing system did not match TVA approved retail rates, (2) the Enhanced Growth Credit (EGC) was incorrectly calculated for two customers, (3) the minimum bill practice for GSA customers differed from the minimum bill provision in the power contract, (4) billing system programming for GSA customer minimum bill calculation differed from the power contract minimum bill provision and the practice described by Volunteer's President, (5) excess demand charges were not automatically calculated in the billing system for GSA customers, and (6) allocations between electric and nonelectric businesses were not approved and did not consider all shared costs and expenses. Volunteer's internal controls could be strengthened related to (1) due diligence in lending process, (2) customer contracts maintenance, (3) customer identification on contract documentation, and (4) accuracy of contract demand in the billing system. Details of the ten areas are discussed below.

Retail Rates in Billing System Did Not Match TVA Approved Retail Rates

We found retail rates charged to customers for some rate classifications did not match the TVA approved retail rates. Specifically, we found incorrect rates applied to (1) Fuel Cost Adjustment (FCA) amounts for various rate classifications for 3 months of the audit period, (2) GSA Part 3 demand charges for 9 months of the audit period, and (3) the customer charge for outdoor lighting for 24 months of the audit period. According to Section 6 of the power contract's "Schedule of Terms and Conditions," the distributor shall adjust the charges in the resale schedules applicable to its customers in accordance with TVA issued adjustment addendums.¹⁵

Incorrect FCA amounts resulted in customers not receiving retail credits of approximately \$11,354. According to Volunteer personnel, 2 months of amounts incorrectly entered into the billing system were due to keying errors. The other month where the FCA amounts were incorrect was due to Volunteer personnel entering FCA information intended for another distributor. TVA originally provided another distributor's retail rates to Volunteer. According to Volunteer personnel, TVA was notified, and the correct Volunteer retail rates were provided; however, the correct Volunteer retail rates were not entered into the billing system.

We also found the GSA Part 3 demand charge for greater than 2,500 kW was incorrect for 9 months of the audit period. The TVA approved rate was \$15.99; however, Volunteer charged \$15.59, which is a difference of 40 cents. The incorrect demand charge did not result in any lost revenue to Volunteer as no GSA Part 3 customers exceeded 2,500 kW in demand during the 9 months. According to Volunteer personnel, the incorrectly entered demand charge was due to a keying error in October 2009 and continued until rates changed in April 2011.

¹⁵ Adjustment addendums provide TVA approved rate adjustments to the distributor.

In addition, we found the customer charge for street and athletic lighting was incorrect for the 24-month audit period. The TVA approved rate was \$10.20; however, Volunteer charged \$14, which is a difference of \$3.80. According to Volunteer personnel, a request was approved by TVA to change the customer charge to \$14 in 2005 when Volunteer revised the GSA Part 1 customer charge. This change was not reflected in the Outdoor Lighting schedule within the power contract. TVA investigated this issue and stated the documentation from Volunteer requesting the change to the Outdoor Lighting customer charge could not be found; however, TVA stated (1) the documentation requesting the change to the GSA Part 1 customer charge was found and (2) noted the change had been made in the GSA schedule. TVA personnel also stated TVA is currently working with Volunteer to submit the paperwork for the request to change the Outdoor Lighting customer charge.

During the exit conference on August 18, 2011, Volunteer personnel stated as of May 2011 all rates are being compared by two Volunteer employees to verify the rates approved by TVA are correctly entered into the billing system.

EGC Not Correctly Calculated

For the month of June 2009, the EGC was incorrectly manually calculated for two of seven customers. Volunteer used the incorrect amount from the declining credit schedule to calculate the customers' EGCs resulting in Volunteer crediting the customers approximately \$332 too much. As a result, Volunteer received a related wholesale EGC credit of 110 percent of the amount applied to customer bills of approximately \$365 too much.

During the exit conference on August 18, 2011, Volunteer personnel stated the billing system programming had been revised in May 2011 to include an automatic calculation of the EGC.

GSA Customer Minimum Bill Practice Differs From Power Contract

We found Volunteer's current practice for determining a GSA customer's minimum bill amount differed from the minimum bill provision in the power contract. According to the GSA schedule provision in the power contract, a customer's monthly minimum bill "shall not be less than the sum of (a) the base customer charge and (b) 1% of the installed cost to the distributor." According to Volunteer's President, this is not the current practice for determining a GSA customer's monthly minimum bill, and he was unaware when the method described in the power contract might have been used at Volunteer. Volunteer's documented method for calculating a GSA customer's monthly minimum bill states a customer's minimum bill "shall not be less than the sum of (a) the base customer charge and (b) \$1 per kW of the higher of (i) the customer's currently effective contract demand or (ii) the highest billing demand in the last 12-month period."

GSA Customer Minimum Bills Not Calculated According to Power Contract or Practice Described by Volunteer President

We found Volunteer's billing system was not calculating GSA customer minimum bills according to the power contract or the practice described above. According to NISC, Volunteer elected not to include minimum bill calculations in the billing system programming for GSA schedule customers; therefore, the billing system does not automatically calculate a minimum bill for customers based on set criteria. According to Volunteer personnel, Volunteer uses a field within the billing system to input a predetermined minimum bill amount for GSA customers. The predetermined amount is calculated as the customer charge plus \$1 per kW of currently effective contract demand, which does not agree with either the power contract minimum bill provision or the practice described above. The billing system compares the customer's calculated bill to the predetermined minimum bill amount and bills the customer for whichever amount is greater. If a predetermined amount is not entered into the billing system, a customer would only be charged the standard customer charge.¹⁶

Excess Demand Charges Not Correctly Calculated for GSA Customers

As described on the previous page, Volunteer did not enter contract demand in the billing system for GSA customers during the audit period. As a result, the billing system does not correctly calculate excess demand charges for GSA Part 3 customers when appropriate. The GSA schedule states that Part 3 customers will incur excess demand charges when the "customer's billing demand exceeds the higher of 2,500 kW or its contract demand." Without a contract demand entered into the billing system, the billing system cannot determine if excess demand charges should be applied to a customer's bill. Volunteer added another field to the billing system to capture contract demand for GSA Part 3 customers for use in the determination of excess demand charges; however, if a value was not entered for a customer in this custom field, the excess demand calculation would not be accurate.

Cost Allocations Not in Place to Adequately Distribute Shared Costs

Cost allocations between Volunteer and other businesses were not made in accordance with a TVA-approved joint cost study. TVA has never performed a joint cost study for Volunteer, although Volunteer has made the request to TVA for a joint cost study. Under the power contract's "Schedule of Terms and Conditions," Section 1(a), the distributor is allowed to "use property and personnel jointly for the electric system and other operations, subject to agreement between Cooperative and TVA as to appropriate allocations."

Volunteer is currently not allocating costs between the electric system and natural gas business and is only allocating billing costs between the electric system and propane business. We found the natural gas and propane businesses shared electric system corporate and customer service personnel; therefore, the natural

¹⁶ The standard customer charge is the amount charged to all GSA customers to receive electric service at the customer location. The customer charge amounts for GSA customers range from \$14 for GSA Part 1 customers to \$150 for GSA Part 3 customers per month.

gas and propane businesses should have allocated costs for payroll, benefits, rent for office space, supplies, etc. We also found the electric department covered the entire cost for facility and communication related expenses that were used by electric system personnel shared with the nonelectric businesses.

Due Diligence in Lending Process Does Not Protect Electric Funds

As described above, Volunteer provided economic development funds to customers through Rural Development grants and intermediary loans. However, the responsibility to perform due diligence in lending lies with the distributor. Volunteer does not currently have a due diligence process beyond management, the Board, and legal counsel review of the customer's Rural Development loan application, which does not include an evaluation of the customer financial position, industry trends, etc. In the event of a customer default on the reloaned funds, the intermediary (Volunteer) would still owe the balance of the loan made from Rural Development. In addition, if a customer defaults on a loan using grant funds, the distributor would be responsible to repay the outstanding obligation if the distributor had not performed adequate due diligence.

In November 2008, one customer with two loans guaranteed by Volunteer totaling approximately \$1.3 million declared bankruptcy and subsequently defaulted on the entire outstanding loan balance due to Volunteer. While performing a limited review of the customer's business plan included in the Rural Development loan application, we found the defaulted customer's revenues relied heavily on sales to one company. When this company suspended operations due to prolonged financial distress, the Volunteer customer could no longer continue operations. As a result, Volunteer seized the collateralized assets of the defaulted customer that were declared to be valued at approximately \$1.8 million in the August 2007 and June 2008 loan applications. Volunteer received approximately \$227,000 (13 percent) of the declared value when it sold the seized assets in January and May 2010. Volunteer applied the receipts from the sales to the approximately \$1.3 million loan balance to reduce the amount Volunteer was obligated to pay to approximately \$1.1 million. With a more comprehensive due diligence in lending process, Volunteer could better protect electric system funds during the intermediary lending process.

Volunteer personnel stated that in the future intermediary loans will no longer be reloaned directly to customers, rather, Volunteer will reloan the funds to the customer's county government who will then reloan the funds to the customer. This practice is designed to add an additional obligated party between Volunteer and Rural Development should a customer default on an intermediary loan. Regardless of whom the intermediary loan funds are reloaned to, Volunteer would still be ultimately responsible for the loaned funds to Rural Development and, without a more comprehensive due diligence in lending process, electric system funds would be at a greater risk. Volunteer does not currently have any intermediary loans other than the two defaulted loans described above.

Volunteer's due diligence related to lending grant funds is limited to executing Uniform Commercial Code filings and maintaining proper records. Without a more comprehensive due diligence in lending process, Volunteer could become responsible for repaying Rural Development for loaned grant funds. This process should include, at a minimum, reviews of customer's independently audited financial statements and appraisals of proposed collateral.

Customer Contracts Not Maintained

We reviewed all 21 customer accounts classified as GSA Part 3 or higher and noted Volunteer did not have a customer contract on file for 4 of the 21 customer accounts. The GSA schedule from TVA requires all customers who exceed 50 kW per month to sign a formal contract. However, TVA management, in response to previous OIG distributor audit reports, indicated the threshold of 50 kW for requiring customer contracts was too low. On February 2, 2011, TVA issued guidance to distributors changing the contract requirement threshold from 50 kW to 1 megawatt with flexibility for distributors to implement a lower limit. The guidance also stated effective, signed contracts should be retained in customer files for all customer accounts that meet the threshold requirement. A demand level of 1 megawatt classifies an account as at least GSA Part 3. Each customer contract includes a contract demand that is used in placing the customer in the correct classification. Contract demand is also used in calculating the customer's billed demand.

Customer Contract Documentation Could Be Improved

One area where internal controls could be strengthened is related to 17 of the 21 GSA Part 3 or higher customer accounts with contracts referred to on the previous page. Customer contracts reviewed did not clearly identify the customer's account number or physical location that was applicable to the contract. Some customers had multiple contracts for multiple meters or locations that were not easily tied to the billing system data. According to Volunteer personnel during the exit conference on August 18, 2011, new contracts show the customer's account number but customer contracts already in existence were not updated to include the customer's account number.

Contract Demand in Billing System Did Not Agree With Contract

Another area where internal controls could be strengthened is entering contract demand in the billing system. We identified six customer accounts where the contract demand per the contract did not agree with the contract demand entered into the billing system. Specifically, we found none of the 6 accounts had contract demand entered into the billing system. Contract demand should be entered into the billing system at the agreed-upon contract amount to ensure proper calculation of the customer's bill for the monthly demand charge and calculating the customer's minimum bill.

TVA OVERSIGHT OPPORTUNITIES

We identified three areas where TVA's oversight of the distributors could be enhanced. Two areas identified are new opportunities to enhance TVA's oversight of the distributors. Specifically, we found TVA has not: (1) provided guidance to distributors regarding a proper due diligence process for loaning Rural Development funds to customers for economic development and (2) included whether a cooperative has performed capital credit allocations¹⁷ as part of the analyses performed in the retail rate setting and approval process. The remaining issue, regarding the lack of a current joint cost study, has been reported in previous OIG distributor audit reports. TVA has agreed to take corrective action on this issue. These three areas are described in detail below.

No Guidance on Proper Due Diligence for Loaning Rural Development Funds

If TVA continues to allow distributors to pledge electric system funds as guarantees for customer economic development loans with Rural Development, TVA could improve oversight of distributors by providing guidance to better protect electric system funds through proper due diligence when loaning Rural Development funds. As stated above, due diligence when lending Rural Development funds is the responsibility of the distributor. We noted Volunteer was not provided with any guidance from TVA, and TVA management confirmed no guidance was provided to distributors regarding a proper due diligence process for loaning Rural Development funds to customers. If a distributor's power contract allows loans through Rural Development or TVA approves a distributor to lend Rural Development funds, it is important for TVA to provide guidance to distributors on what should be included in a comprehensive due diligence process to better protect electric system funds during the loaning of Rural Development funds.

No Inclusion of Capital Credit Allocations in Rate Analysis

Another area where TVA could improve oversight of distributors is by including whether a cooperative has performed capital credit allocations¹⁸ as part of the analyses performed in the retail rate setting and approval process. According to Volunteer personnel, Volunteer had performed a capital credit allocation as required by the Internal Revenue Service to maintain its nonprofit status but had not paid out any capital credits to cooperative members. According to TVA management, distributors are allowed to perform capital credit allocations but are not allowed to pay capital credits. Instead, distributors are expected to use the excess funds to reduce rates or improve the electric system. In addition, TVA management indicated consideration of whether a capital credit allocation has

¹⁷ Capital credits are similar to dividends that are payable to members of a cooperative. Capital credits must be allocated when a cooperative achieves an equity level defined by RUS. TVA prohibits capital credit allocations to be paid to members and instead encourages cooperatives to reinvest in the electric system or lower electric rates.

¹⁸ A capital credit allocation is the process that is performed to take the margins for a calendar year and spread them proportionally to the members during the year margins occurred.

been made was not included in the retail rate setting and approval process. Including such consideration in the retail rate setting and approval process could enhance the analyses and may provide additional insight on the appropriateness of a rate increase or decrease.

We also noted one issue for Volunteer that was reported in previous OIG distributor audit reports. Specifically, we noted TVA has never performed a joint cost study for Volunteer. The Accountants' Reference Manual states a joint cost study should be performed every three to four years or when a significant change occurs. In response to the previous reports, TVA agreed to take corrective actions on this issue.

Full discussion of the previously reported issues and TVA's planned actions can be found in prior OIG distributor audit reports on our Web site, www.oig.tva.gov.

RECOMMENDATIONS

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

1. Discontinue or obtain TVA approval for the practice of pledging electric funds to guarantee Rural Development loans to customers.

Volunteer's Response – Volunteer disagreed with this recommendation and stated the TVA OIG did not provide written documentation to substantiate its statement that Rural Development could, under a very unlikely circumstance, require Volunteer to repay the grants. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with the recommendation and stated they plan to recommend formal approval by the TVA Board of a Use of Revenues policy that expressly approves distributor participation in the United States Department of Agriculture (USDA) Rural Economic Development Loan and Grant Program. See Appendix C for TVA's complete response.

Auditor's Response – As stated in the body of the report, loans and grants to customers are not allowed under the terms of the current power contract. However, if the TVA Board approves a policy as described in TVA management's response, this practice may no longer be a violation of the power contract provisions.

In regard to Volunteer's statement that the OIG did not provide documentation to substantiate its statement that Rural Development could require the distributor to repay grants, the documentation was actually provided to the OIG by Volunteer. Specifically, Volunteer management

provided the OIG with an e-mail from its Rural Development Area Specialist that stated, "If our agency proved that due diligence was not performed by the cooperative then they would be liable for the entire amount."

2. Discontinue the use of electric funds for unapproved purposes, such as the leasing of diesel generators to customers.

Volunteer's Response – Volunteer disagreed that electric funds had been used for this purpose and stated the TVA OIG failed to do its due diligence in accounting on this issue. Volunteer further stated it had provided the TVA OIG with proper accounting and amounts to verify that no electric funds have been used for this purpose and the TVA OIG chose to ignore this information. In addition, Volunteer (1) provided a letter from an accounting firm to verify that no electric funds had been used on this project and (2) stated it has an agreement with this customer to reimburse Volunteer for the balance of the cost of the generators if the plant were to shut down. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed distributors should not use electric funds for unapproved purposes. TVA management stated it is still investigating the facts surrounding the lease of the diesel generators to determine if other electric rate payers are bearing any undue risk for the lease that amounts to discrimination in favor of the leasing customer. TVA further stated that if it finds any such discrimination, appropriate action will be taken to achieve power contract compliance. See Appendix C for TVA's complete response.

Auditor's Response – As stated at the beginning of our report, our audit covers the period of July 2008 through June 2010. During that period, Volunteer reduced the mentioned customer's monthly lease payment from \$29,300 (an amount that Volunteer management told us would result in a break-even situation) to \$10,000 (an amount that was \$7,580 less than Volunteer's monthly lease payment for the generators, not including operation and maintenance costs). During our audit period, the lower monthly lease payment for the customer was in place for 18 months.

With regard to Volunteer's statement that its accounting firm verified that no electric funds had been used on this project, the letter from Volunteer's accounting firm stated, "We have not audited or reviewed the foregoing information, and consequently take no responsibility for the underlying amounts, assumptions, or projected values." Both Volunteer and its accounting firm made assumptions regarding future payment in arriving at their conclusions; the OIG made no assumptions and based its calculations on comments from Volunteer management and actual lease documentation. (Also, since completion of our audit field work, it has been reported that the customer in question will close its doors by the end of the year.)

The OIG concurs with TVA's planned action to investigate the facts surrounding the lease of the diesel generators to determine if other electric rate payers are bearing any undue risk for the lease that amounts to discrimination in favor of the leasing customer.

3. Obtain TVA approval for investments of reasonable reserves in nonelectric businesses.

Volunteer's Response – Volunteer agreed and stated it will work with TVA to resolve. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA agreed with the recommendation and stated that in relation to recommendations 3, 4, 5, and 6, TVA will approve investments of electric system reserves only where the investments are made in accordance with TVA guidelines for such investments. TVA further stated, where any electric system assets are used or pledged in violation of the requirements of the power contract, TVA will seek to have the distributor promptly remedy those violations as soon as possible and in a manner that best protects the electric rate payers in the circumstances. See Appendix C for TVA's complete response.

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

4. Obtain repayment of balances due on loans from the electric system to nonelectric businesses or approval from TVA to invest reasonable reserves through loans to nonelectric businesses.

Volunteer's Response – Volunteer agreed with the recommendation and stated it will work with TVA to obtain approval to invest in nonelectric businesses. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA agreed with the recommendation and stated it will take the actions discussed in 3 above. See Appendix C for TVA's complete response.

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

5. Execute loan documents between the electric department and nonelectric businesses for any TVA approved investments of reasonable reserves as loans to nonelectric businesses. Loan documents should include interest rates to be paid by the nonelectric businesses, terms for payback, recourse available to the electric department if the nonelectric business is unable to make payments on a timely basis, and any other protections available to the electric rate payer.

Volunteer's Response – Volunteer agreed with this recommendation and stated it will work to have these documents in place by October 2012. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA agreed with the recommendation and stated it will take the actions discussed in 3 above. See Appendix C for TVA's complete response.

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

6. Discontinue the practice of pledging electric system assets as guarantees for nonelectric businesses and have the electric department removed from current loans as a guarantor.

Volunteer's Response – Volunteer stated it does not plan to start any additional nonelectric businesses but stated it is not feasible to have the electric system assets removed from current loan guarantees at this time. However, Volunteer agreed that if in the future cash flows improve for the natural gas system, it can explore possible options at that time. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA agreed with the recommendation and stated it will take the actions discussed in 3 above. See Appendix C for TVA's complete response.

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

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

Volunteer's Response – Volunteer agreed and stated its staff will review reports on a quarterly basis that may reflect multiple residential accounts for one location address or corporate accounts with residential classifications. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed the power contract requires consistent classification of customers in accordance with the applicable rate schedule and noted the distributor will work with its billing service provider to resolve misclassifications where they exist. See Appendix C for TVA's complete response.

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

8. Review the remaining accounts identified by the OIG as potentially misclassified based on customer name and/or the existence of multiple accounts at the same address and correct misclassifications where applicable.

Volunteer's Response – Volunteer stated the remaining accounts have been reviewed, and the accounts have been reclassified as needed. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with the recommendation and stated the distributor had investigated potential misclassifications identified by the OIG and made corrections where necessary. See Appendix C for TVA's complete response.

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

9. Enter customer contract demand into the billing system for GSA Part 3 customers and use contract demand in conjunction with peak billing demand in a 12-month period to classify GSA Part 3 customers as required by the power contract.

Volunteer's Response – Volunteer agreed with this recommendation and stated these issues had already been corrected. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with the recommendation and stated the distributor had entered contract demand into the billing system for GSA Part 3 customers and classified customers in accordance with the distributor rate schedule. See Appendix C for TVA's complete response.

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

10. Document evaluations of GSA customer accounts for a demand meter when energy takings exceed 25,000 kWh in accordance with TVA guidance issued in February 2010.

Volunteer's Response – Volunteer stated it is currently adding additional notes to the accounts as they are reviewed and will add additional language to the documentation. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed the distributor should install a demand meter for customers that use greater than 25,000 kWh per billing period or document the reason whether a demand meter is needed. TVA also stated the distributor will review accounts that have usage greater than 25,000 kWh to see if they require demand meters. See Appendix C for TVA's complete response.

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

11. Revise the current practice for determining GSA customer minimum bills to reflect the minimum bill provision within the GSA schedule of the power contract or work with TVA to revise the power contract to reflect a practice acceptable to TVA and Volunteer.

Volunteer's Response – Volunteer stated it had already requested TVA change the GSA minimum bill contract language to match Volunteer's language and stated that TVA is working on the new contract language. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with this recommendation and stated they will work with the distributor to remedy any noncompliance with the power contract and rate schedule requirements regarding minimum bills. See Appendix C for TVA's complete response.

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

12. Enter customer contract demand into the billing system for all GSA Part 3 customers and use contract demand in conjunction with peak billing demand to apply excess demand charges as required by the power contract.

Volunteer's Response – Volunteer stated it had already entered the contract demand information into its billing system and is working with its software vendor, NISC, to implement the excess demand charge. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with this recommendation and stated the distributor is working with the software vendor to make this change. See Appendix C for TVA's complete response.

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

13. Revise billing system programming to calculate minimum bills for GSA customers according to the minimum bill provision within the GSA schedule of the power contract or any new provision agreed to by TVA and Volunteer.

Volunteer's Response – Volunteer stated it is working on implementing this programming fix with its software provider, NISC. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with this recommendation and stated the distributor will work with its software vendor to make this change. See Appendix C for TVA's complete response.

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

14. Allocate all shared costs and expenses between the electric system and the natural gas and propane businesses based on percentage of use by each business.

Volunteer's Response – Volunteer stated it has been allocating costs through a management fee charged to its propane business, and TVA plans to have a joint cost study completed by October 2012. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed that the allocation of joint costs should be updated and then applied across the different divisions that share assets and resources. TVA also stated TVA field accountants will complete the study within the next year and work with the distributor to agree on and implement any changes required. See Appendix C for TVA's complete response.

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

15. Develop and implement a more comprehensive due diligence in lending process to reduce the risk to the electric system when acting as an intermediary or providing loans under the Rural Development grant programs.

Volunteer's Response – Volunteer disagreed and stated it already had a process in place that requires past financial records, future financial projections, business plan, and additional information from the organization requesting economic development loans and that the information is reviewed by Volunteer management, legal counsel, and the Board of Directors. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with the recommendation and stated TVA management is working with the distributors and the TVA Board to update the policies and processes for Use of Revenues as part of the role as regulator effort. TVA also stated additional due diligence measures, if any, will be discussed and resolved as a part of this effort. See Appendix C for TVA's complete response.

Auditor's Response – The OIG reviewed customer Rural Development applications for loans and grants and noted applications do not include an evaluation of the customer financial position, industry trends, independently audited financial statements, or appraisals of proposed collateral. Further, in November 2008, Volunteer became responsible for repaying approximately \$1.1 million in debt owed by a customer who declared bankruptcy due to financial insolvency. Volunteer made loans to the customer in August 2007 and June 2008 (just 5 months before the customer declared bankruptcy).

The OIG concurs with TVA's planned actions and maintains that more comprehensive due diligence in lending is needed to reduce the risk to the electric system when a distributor acts as an intermediary or provides loans under the Rural Development grant programs.

16. Obtain and maintain properly executed effective customer contracts for all GSA Part 3 and higher customers.

Volunteer's Response – Volunteer agreed with this recommendation and stated it is continually updating and obtaining new contracts for GSA Part 3 customers. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed with this recommendation and stated the distributor will work with GSA Part 3 customers whose contract demand exceeds 1 megawatt to obtain signed contracts. See Appendix C for TVA's complete response.

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

17. Update existing customer contracts to include additional information to easily identify contracts for customers with multiple meters or locations.

Volunteer's Response – Volunteer stated it made changes to its contract format 3 years ago to make the contract easier to identify and that going forward this will be covered. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed that it is good business practice and stated Volunteer has made changes to its contract format for contracts going forward for easy identification. See Appendix C for TVA's complete response.

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

18. Implement a process to ensure all customers with contracts have the appropriate contract demand entered into the billing system and the contract demand values in the system agree with the customer's contract.

Volunteer's Response – Volunteer agreed with this recommendation and stated its staff is currently entering all contract demands into the billing system. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management agreed that the distributor should have good internal controls in place that will ensure data is correctly entered into the system and stated the distributor will implement a process to identify and verify contract demand. See Appendix C for TVA's complete response.

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

The Group President, Strategy and External Relations, should:

19. Discontinue the practice of allowing distributors to pledge electric system funds as guarantees for customer economic development loans with Rural Development and communicate this to all affected distributors. If TVA determines to continue this practice, we recommend the affected distributors' power contracts be modified to provide for a designated amount of electric system funds that may be pledged for economic development purposes annually after adequate due diligence is performed and appropriate protections are put in place for the rate payers.

TVA Management's Comments – TVA management agreed this practice is not expressly allowed under the power contract and stated TVA plans to recommend formal approval by the TVA Board of a Use of Revenues policy that expressly approves distributor participation in the USDA Rural Economic Development Loan and Grant Program. See Appendix C for TVA's complete response.

Auditor's Response – The OIG concurs that loans and grants to customers are not allowed under the terms of the current power contract. If the TVA Board approves a policy as described in the TVA management response, this practice may no longer be a violation of contract provisions.

20. Evaluate the response to Recommendation 21 and, if TVA allows distributors to continue pledging electric system funds as guarantees for customer economic development loans with Rural Development, then develop and provide guidance to distributors outlining a proper due diligence process to be followed when loaning Rural Development funds to customers for economic development.

TVA Management's Comments – TVA management stated they plan to allow distributors to continue the practice of pledging electric system funds as guarantees for customer economic development loans with Rural Development and will educate them on the need to follow RUS guidelines, including appropriate due diligence. TVA management also stated they are working with the distributors and the TVA Board to update the policies and processes for Use of Revenues as part of the role as regulator effort, and additional due diligence measures, if any, will be discussed and resolved as a part of this effort. See Appendix C for TVA's complete response.

Auditor's Response – The OIG concurs with the planned actions to develop additional due diligence measures.

21. Consider capital credit allocations in the TVA analyses performed during the retail rate setting and approval process.

Volunteer's Response – Although this was a recommendation for TVA, Volunteer management also responded to this recommendation stating its disagreement. See Appendix B for Volunteer's complete response.

TVA Management's Comments – TVA management stated distributors are free to perform capital credit allocations but are not allowed to pay out capital credits under Section 6 of the power contract. TVA management also stated they had reviewed Volunteer's capital credit allocation for FY 2010 and determined that the methodology allocated its FY 2010 net income to the end use customer classes. TVA further stated it understands that cooperatives do not adjust net income before calculating capital credits. Since net income is a key metric that TVA uses in its revised retail ratemaking and approval process, consideration of the relevant information provided by Volunteer's capital credit allocations is inherent in the review process. TVA management concluded that they believe the recommendation is unnecessary because it brings no additional value to the retail ratemaking process. See Appendix C for TVA's complete response.

Auditor's Response – Although Volunteer provided comments to this recommendation, the recommendation was only for TVA's consideration in developing its rate setting practices going forward. During performance of the audit, TVA management indicated to the OIG that TVA was not considering whether a distributor had been required to make a capital credit allocation during the TVA rate approval process. However, based on the supplemental information provided by TVA management, the OIG concurs that the new ratemaking and approval process should provide for adequate consideration of any capital credit allocations.

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 TVA and Volunteer 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
 - 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. Reviewed results of the queries and, using nonstatistical sampling, selected accounts 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.
- Determined through inquiry and review of documentation whether Volunteer had any nonelectric, system-related business interests supported by electric system funds.
- Obtained disbursements listing for the audit period. Reviewed and analyzed disbursements to identify instances where electric system funds may have been used for purposes not allowed under the TVA power contract. 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 will use both qualitative and quantitative factors when considering the significance of an item. For the purposes of this audit the quantitative factor(s) to be considered in determining an item's significance are:

- If the dollar value of an error(s) and/or item of noncompliance with the contract exceeds 3 percent of the distributor's average annual power cost during the audit period, or \$4,859,347.82, it would be considered significant.
- In respect to the distributor's unapproved Use of Revenues, we consider the following to be significant.
 - A negative cash ratio results after subtracting the distributor's funds at risk during the audit period (loans extended or debts guaranteed with electric revenues) from the cash and cash equivalents balance at the end of the audit period.
 - Amounts expended by the electric department on behalf of a nonelectric department/operating unit during the audit period (without payback from the nonelectric department) exceed the rate increase amounts approved by TVA during the audit period.

The scope of the audit was for the period July 2008 through June 2010. Fieldwork was conducted April through July 2011 and included visiting the distributor's corporate office in Decatur, Tennessee. 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 the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



CORPORATE OFFICE: 18359 HWY. 58 N., P.O. BOX 277, DECATUR, TN 37322 (423) 334-1020

October 25, 2011

Mr. Robert Martin
Assistant Inspector General
Office of Inspector General
400 west Summit Hill Drive, ET 4C-K
Knoxville, TN 37902-1401

Response to Draft Audit of Volunteer Energy Cooperative

Dear Mr. Martin:

The following is Volunteer Energy Cooperative's response to the findings and recommendations of the TVA OIG review of Volunteer Energy Cooperative (VEC). The TVA OIG recommendations are listed first, along with the response from VEC.

1. Discontinue or obtain TVA approval for the practice of pledging electric funds to guarantee Rural Development loans to customers.

Response: VEC disagrees with this recommendation. Both VEC and TVA have been committed to economic development for the Tennessee Valley for over 75 years. Some of the loans reviewed by the TVA OIG are grants from Rural Development and there are no liabilities for VEC associated with these grants, and no electric funds were utilized. The TVA OIG did not provide any written documentation to substantiate their statement that Rural Development could, under a very unlikely circumstance, require VEC to repay the grants. To provide VEC with more assurance on loans, VEC changed our policy two years ago and will only loan to local government. The local county then has to guarantee the loan payments back to VEC. In addition VEC has always attached a UCC-1 fixture filing, duly recorded in the county records to property associated with the loan.

2. Discontinue the use of electric funds for unapproved purposes, such as the leasing of diesel generators to customers.

Response: VEC disagrees with the assertion that any electric funds have been used for this purpose. The TVA OIG failed to do their due diligence in accounting on this issue. On page 5 of the draft report it states "Volunteer used approximately \$347,000 in electric funds for lease payments and operating costs associated with maintaining generators at a customer location".

Service Centers:

BENTON P.O. Box 690 Benton 37307 423-338-2569	BYRISTOWN P.O. Box 9 Byrystown 38549 931-864-3685	CLEVELAND P.O. Box 2578 Cleveland 37320 423-476-6571	CROSSVILLE P.O. Box 609 Crossville 38557 931-484-3527	DECATUR P.O. Box 1183 Decatur 37322 423-334-5721	GEORGETOWN P.O. Box 1 Georgetown 37336 423-344-8382	JAMESTOWN P.O. Box 1450 Jamestown 38356 931-879-5853	MONTEREY P.O. Box 67 Monterey 38574 931-839-2217	SPRING CITY P.O. Box 177 Spring City 37381 423-365-5220
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This is an incorrect number and no electric funds have been used for the stated generators. Total cash flow from this project for VEC has exceeded costs. VEC provided the TVA OIG with proper accounting and amounts to verify that no electric funds have been used for this purpose and the TVA OIG chose to ignore this information. We are providing a letter from the accounting firm that audits VEC that verifies that no electric funds have been used on this project. In addition VEC has an agreement with this company to reimburse VEC for the balance of the cost of the generators if the plant were to shut down. This recommendation should be removed from the final report issued by the TVA OIG since it has no basis in fact.

3. Obtain TVA approval for investments of reasonable reserves in nonelectric businesses.

Response: *VEC agrees with this statement and will work with TVA to resolve.*

4. Obtain repayment of balances due on loans from electric system to nonelectric businesses or approval from TVA to invest reasonable reserves through loans to nonelectric businesses.

Response: *VEC will work with TVA to obtain approval to invest in nonelectric businesses. Target completion date is October 2012. Items 3 and 4 are the same issue.*

5. Execute loan documents between the electric department and nonelectric businesses for any TVA approved investments of reasonable reserves as loans to nonelectric businesses. Loan documents should include interest rates to be paid by the nonelectric businesses, terms for payback, recourse available to the electric department if the nonelectric business is unable to make payments on a timely basis, and any other protections available to the electric rate payer.

Response: *We are in agreement on this recommendation. We will work to have these documents in place by October 2012.*

6. Discontinue the practice of pledging electric system assets as guarantees for nonelectric businesses and have the electric department removed from current loans as a guarantor.

Response: *We do not plan to start any additional nonelectric businesses. It is not feasible to have the electric system assets removed from current loan guarantees at this time. In the future if the cash flows improve for the natural gas system, we can explore possible options at that time.*

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

Response: *VEC staff will review reports on a quarterly basis that may reflect multiple residential accounts for one location address or corporate accounts with residential classifications.*

8. Review the remaining accounts identified by the OIG as potentially misclassified based on customer name and/or the existence of multiple accounts at the same address and correct misclassifications where applicable.

Response: *The remaining have been reviewed and the accounts have been reclassified as needed.*

9. Enter customer contract demand into the billing system for GSA Part 3 customers and use contract demand in conjunction with peak billing demand in a 12-month period to classify GSA Part 3 customers as required by the power contract.

Response: *We agree with this recommendation, and these have already been corrected.*

10. Document evaluations of GSA customer accounts for a demand meter when energy takings exceed 25,000 kWh in accordance with TVA guidance issued in February 2010.

Response: *VEC has been doing these types of evaluations for years. We are currently adding additional notes to the accounts as they are reviewed and will add additional language on documentation.*

11. Revise the current practice for determining GSA customer minimum bills to reflect the minimum bill provision within the GSA schedule of the power contract or work with TVA to revise the power contract to reflect a practice acceptable to TVA and Volunteer.

Response: *We have already requested to TVA that they change the GSA minimum bill language to match VEC's, and TVA is working on the new contract language. Expected completion date by October 2012.*

12. Enter customer contract demand into the billing system for all GSA Part 3 customers and use contract demand in conjunction with peak billing demand to apply excess demand charges as required by the power contract.

Response: *We have already entered the contract demand information into our billing system. We are working with our software vendor NISC to implement the excess demand charge.*

13. Revise billing system programming to calculate minimum bills for GSA customers according to the minimum bill provisions within the GSA schedule of the power contract or any new provision agreed to by TVA and Volunteer.

Response: *We are working on implementing this with our software provider NISC. We anticipate having this completed by June 2012.*

14. Allocate all shared costs and expenses between the electric system and the natural gas and propane businesses based on percentage of use by each business.

Response: *We have already been allocating costs through a management fee charged to our propane business. We have also made multiple requests to TVA over the last two years for a joint cost study to be completed. TVA plans to have the joint cost study completed by October 2012.*

15. Develop and implement a more comprehensive due diligence in lending process to reduce the risk to the electric system when acting as an intermediary or providing loans under the Rural Development grant programs.

Response: *VEC disagrees with this assertion. We already have a process in place that requires past financial records, future financial projections, business plan, and additional information from the organization requesting economic development loans. This information is reviewed by VEC management, legal counsel, and the Board of Directors. In many cases there are other agencies, such as TVA, that perform their own evaluation and make loans to the same companies.*

In addition to our financial review, two years ago we changed our policy to give additional assurance to VEC to reduce the risk. As stated in our response in number 1, we have gained additional security by changing our policy to only lend to local government. We do not agree with the TVA OIG statement, during our exit interview, that county governments in Tennessee will go bankrupt. The TVA OIG could not provide any documentation to support the claim that counties in Tennessee can go bankrupt.

16. Obtain and maintain properly executed effective customer contracts for all GSA Part 3 and higher customers.

Response: *We agree with this recommendation. We are continually updating and obtaining new contracts for GSA part 3 customers.*

17. Update existing customer contracts to include additional information to easily identify contracts for customers with multiple meters or locations.

Response: *We made changes to our contract format three years ago to make the contract easier to identify. Going forward this will be covered.*

18. Implement a process to ensure all customers with contracts have the appropriate contract demand entered into the billing system and the contract demand values in the system agree with the customer's account.

Response: *We agree with this recommendation. VEC staff is currently entering all contract demands into the billing system.*

To Group President, Strategy and External Relations should:

21. Consider capital credit allocations in the analyses performed during the retail rate setting and approval process.

Response: *VEC disagrees with this statement. We have included with our response an attachment with letters and case history provided from our attorney. Since this would result in a violation of the TVA power contract with VEC, and is contrary to case law in the State of Tennessee, this recommendation should be removed from the report.*

Sincerely,



Rody Blevins
President/CEO

Copy: Kim Greene, TVA

October 31, 2011

Robert E. Martin, ET 3C-K

RESPONSE TO DRAFT AUDIT REPORT 2010-13285 – DISTRIBUTOR REVIEW OF
VOLUNTEER ELECTRIC COOPERATIVE (VEC)

This is in response to your memorandum to me dated August 26, 2011.

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.

A. Recommendations

1. Discontinue or obtain TVA approval for the practice of pledging electric funds to guarantee Rural Development loans to customers.
 - o TVA management agrees with the recommendation.
 - o The USDA Rural Economic Development Loan and Grant program is an important economic development tool for the Valley. TVA management plans to recommend to the Board that it formally approve a use of revenues policy which expressly approves of a distributor's participation in the USDA Rural Economic Development Loan and Grant Program. TVA will educate distributors on the importance of following the RUS guidelines, including appropriate due diligence on any such loans.
 - o **Actions taken or planned, and completion dates:** TVA management plans to recommend to the Board to formally approve a use of revenues policy which expressly approves distributor participation in the USDA Rural Economic Development and Grant Program. Target completion date is June 2012.
2. Discontinue the use of electric funds for unapproved purposes, such as the leasing of diesel generators to customers.
 - o TVA management agrees that a distributor should not use electric funds for unapproved purposes.
 - o **Actions taken or planned, and completion dates:** TVA management is investigating the facts surrounding the lease of the diesel generators. TVA will determine if other electric rate payers are bearing any undue risk for the lease that amounts to discrimination in favor of the leasing customer. If TVA finds any such discrimination, appropriate action will be taken to achieve Power Contract compliance. However, nothing in the Power Contract prohibits a distributor from offering a service to provide, operate, and maintain diesel generators for its customer so long as the costs associated with such provision, operation, and maintenance are properly borne by the customer

Robert Martin
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contracting for such service and are not shifted to VEC's other ratepayers.
Target completion date is October 2012.

3. Obtain TVA approval for investments of reasonable reserves in nonelectric businesses.
4. Obtain repayment of balances due on loans from the electric system to nonelectric businesses or approval from TVA to invest reasonable reserves through loans to nonelectric businesses.
5. Execute loan documents between the electric department and nonelectric businesses for any TVA approved investments of reasonable reserves as loans to nonelectric businesses. Loan documents should include interest rates to be paid by the nonelectric businesses, terms for payback, recourse available to the electric department if the nonelectric business is unable to make payments on a timely basis, and any other protections available to the electric rate payer.
6. Discontinue the practice of pledging electric system assets as guarantees for nonelectric businesses and have the electric department removed from current loans as a guarantor.
 - o TVA management agrees with the related recommendations 3, 4, 5, and 6.
 - o **Actions taken or planned, and completion dates:** TVA will approve investments of electric system reserves only where the investments are made in accordance with TVA guidelines for such investments. Where any electric system assets are used or pledged in violation of the requirements of the Power Contract, TVA will seek to have the distributor promptly remedy those violations as soon as possible and in a manner that best protects the electric ratepayers in the circumstances. Target completion date is October 2012.
7. Implement procedures to assist in identifying residential accounts that need to be reclassified as commercial when service starts or changes to a nonresidential type (i.e. business or a separately metered structure).
 - o TVA management agrees that the Power Contract requires consistent classification of customers in accordance with the applicable rate schedule.
 - o **Actions taken or planned, and completion dates:** The distributor will work with its billing service provider to resolve misclassifications where they exist. Target completion date is October 2012.
8. Review the remaining accounts identified by the Office of the Inspector General (OIG) as potentially misclassified based on customer name and/or the existence of multiple accounts at the same address and correct misclassifications where applicable.
 - o TVA management agrees with the recommendation.

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- o **Actions taken or planned, and completion dates:** The distributor has investigated potential misclassifications identified by the OIG and made corrections where necessary.
9. Enter customer contract demand into the billing system for GSA Part 3 customers and use contract demand in conjunction with peak billing demand in a 12-month period to classify GSA Part 3 customers as required by the Power Contract.
- o TVA management agrees with the recommendation.
 - o **Actions taken or planned, and completion dates:** The distributor has entered contract demand into the billing system for GSA Part 3 customers and classified customers in accordance with the distributor rate schedule.
10. Document evaluations of GSA customer accounts for a demand meter when energy takings exceed 25,000 kWh in accordance with TVA guidance issued in February 2010.
- o TVA management agrees that that the distributor should install a demand meter for customers that use greater than 25,000 kWh per billing period or document the reason whether a demand meter is needed.
 - o **Actions taken or planned, and completion dates:** The distributor will review accounts that have usage greater than 25,000 to see if they require demand meters. Target completion date is October 2012
11. Revise the current practice for determining GSA customer minimum bills to reflect the minimum bill provision within the GSA schedule of the Power Contract or work with TVA to revise the Power Contract to reflect a practice acceptable to TVA and VEC.
- o TVA management agrees with this recommendation.
 - o **Actions taken or planned, and completion dates:** TVA will work with the distributor to remedy any noncompliance with Power Contract and rate schedule requirements regarding minimum bills. Target completion date is October 2012.
12. Enter customer contract demand into the billing system for all GSA Part 3 customers and use contract demand in conjunction with peak billing demand to apply excess demand charges as required by the Power Contract.
- o TVA management agrees with this recommendation,
 - o **Actions taken or planned, and completion dates:** The distributor is working with their software vendor to make this change. Target completion date is October 2012.
13. Revise billing system programming to calculate minimum bills for GSA customers according to the minimum bill provision within the GSA schedule of the Power Contract or any new provision agreed to by TVA and VEC.
- o TVA management agrees with this recommendation.

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- **Actions taken or planned, and completion dates:** The distributor will work with their software vendor to make this change. Target completion date is June 2012.
14. Allocate all shared costs and expenses between the electric system and the natural gas and propane businesses based on the percentage of use by each business.
- TVA management agrees that the allocation of joint costs should be updated and then applied across the different divisions that share assets and resources.
 - **Actions taken or planned, and completion dates:** TVA field accountants will complete the study within the next year and work with the distributor to agree on and implement any changes required. Target completion date is October 2012.
15. Develop and implement a more comprehensive due diligence in the lending process to reduce the risk to the electric system when acting as an intermediary or providing loans under the rural development grant programs.
- TVA management agrees with this recommendation.
 - **Actions taken or planned, and completion dates:** TVA management is working with the distributors and the TVA Board to update the policies and processes for use of revenues as part of the role of regulator effort. Additional due diligence measures, if any, will be discussed and resolved as a part of this effort. Target completion date is October 2012.
16. Obtain and maintain properly executed effective customer contracts for all GSA Part 3 and higher customers.
- TVA management agrees with this recommendation.
 - **Actions taken or planned, and completion dates:** The distributor will work with GSA Part 3 customers whose contract demand exceeds 1 MW to obtain signed contracts. Target completion date is October 2012.
17. Update existing customer contracts to include additional information to easily identify contracts for customers with multiple meters or locations.
- TVA management agrees that is good business practice.
 - **Actions taken or planned, and completion dates:** VEC has made changes to their contract format for contracts going forward for easy identification.
18. Implement a process to ensure all customers with contracts have the appropriate contract demand entered into the billing system and the contract demand values in the system agree with the customer's contract.

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- TVA management agrees that the distributor should have good internal controls in place that will ensure data is correctly entered into the system.
 - **Actions taken or planned, and completion dates:** The distributor will implement a process to identify and verify contract demand. Target completion date is October 2012.
19. Discontinue the practice of allowing distributors to pledge electric system funds as guarantees for customer economic development loans with rural development and communicate this to all affected distributors. If TVA determines to continue this practice, we recommend the affected distributors' Power Contracts be modified to provide for a designated amount of electric system funds that may be pledged for economic development purposes annually after adequate due diligence is performed and appropriate protections are put in place for the rate payers.
- As stated in response to recommendation 1, The USDA Rural Economic Development Loan and Grant program is an important economic development tool for the Valley. TVA management plans to recommend to the Board that it formally approve a use of revenues policy which expressly approves of a distributor's participation in the USDA Rural Economic Development Loan and Grant Program
 - **Actions taken or planned, and completion dates:** TVA management plans to recommend to the Board to formally approve a use of revenues policy which expressly approves a distributor's participation in the USDA Rural Economic Development and Grant Program. Target completion date is October 2012.
20. Evaluate the response to recommendation 19 and, if TVA allows distributors to continue pledging electric system funds as guarantees for customer economic development loans with rural development, then develop and provide guidance to distributors outlining proper due diligence process to be followed when loaning rural development funds to customers for economic development.
- As stated in response to recommendation 19 above, TVA management plans to allow distributors to continue the practice of pledging electric system funds as guarantees for customer economic development loans with rural development and will educate them on the need to follow RUS guidelines including appropriate due diligence.
 - **Actions taken or planned, and completion dates:** TVA management is working with the distributors and the TVA Board to update the policies and processes for use of revenues as part of the role of regulator effort. Additional due diligence measures, if any, will be discussed and resolved as a part of this effort. Target completion date is October 2012.
21. Consider capital credit allocations in the analyses performed during the retail rate setting and approval process.
- TVA management does not agree with the recommendation.

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- **Actions taken or planned, and completion dates:** As the discussion on page 23 of the draft report points out, distributors are free to perform capital credit allocations but are not allowed to pay out capital credits under Section 6 of the Power Contract. TVA management reviewed VEC's capital credit allocation for FY 2010 and determined that the methodology allocated VEC's FY 2010 net income to the end use customer classes. TVA understands that cooperatives do not adjust net income before calculating capital credits. Since net income has, and will be, a key metric that TVA uses in the revised retail ratemaking and approval process, consideration of the relevant information provided by the VEC capital credit allocations is inherent in the review process. Moreover, the draft recommendation has created confusion and concern by VEC and their legal counsel in regard to TVA's position on capital credits. Because TVA management believes this recommendation brings no additional value to the retail ratemaking process but will create confusion and concern among distributors, we believe that this recommendation is unnecessary.



Kimberly S. Greene
Group President, Strategy & External Relations
WT 7B-K

VB:JSE

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