Memorandum from the Office of the Inspector General

September 9, 2010

Kimberly S. Greene, WT 7B-K

REQUEST FOR FINAL ACTION – AUDIT 2009-12594 – DISTRIBUTOR REVIEW OF LENOIR CITY UTILITIES BOARD

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 Melissa M. Neusel, Project Manager, at (865) 633-7357 or Jill M. Matthews, Deputy Assistant Inspector General, Audits and Support, at (865) 633-7430. We appreciate the courtesy and cooperation received from your staff during the audit.

Robert E Martin

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

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OIG File No. 2009-12594

Office of the Inspector General

Audit Report

To the Group President, Strategy and External Relations

DISTRIBUTOR REVIEW OF LENOIR CITY UTILITIES BOARD

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Audit 2009-12594
September 9, 2010

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APPENDICES

EXECUTIVE SUMMARY

Why the OIG Did This Review

As part of the annual audit plan, the OIG (Office of the Inspector General) performed a review of the Lenoir City Utilities Board (LCUB), which is a distributor for Tennessee Valley Authority (TVA) power based in Lenoir City, Tennessee. Annual revenues from electric sales were approximately $151 million in fiscal year 2009. LCUB also operates nonelectric businesses that include gas, water, and sewer utilities. The objective of the review was to determine compliance with key provisions of the power contract between TVA and LCUB.

What the OIG Found

Our review of LCUB found improvements were needed in the areas of:

- **Customer Classification and Metering** – We identified 102 customer accounts not classified correctly and two metering issues that could impact (1) the proper reporting of electric sales and/or (2) nondiscrimination in providing power to members of the same rate class. We were unable to estimate the monetary effect of all the classification and metering issues because in some instances information was not available; however, for those instances where information was available, the monetary effect on LCUB and TVA would not be material.
- **Contract Compliance** – We identified two areas where LCUB was not meeting power contract requirements with TVA. Specifically, we found (1) customers without a contract and (2) certain joint costs were not allocated between service departments.
- **Distributor Internal Controls** – We identified two areas where LCUB could strengthen internal controls. Specifically, we found improvements could be made with respect to (1) accuracy of contract demand entered in the billing system and (2) developing policies to improve controls over charitable contributions.

In addition, we found LCUB had enough cash on hand to cover planned capital projects and provide a cash reserve of about 8 percent, which is within TVA's established guidelines for adequate cash reserves of 5 to 8 percent.

Finally, we identified a new opportunity to enhance TVA's oversight of the distributors. We found TVA has not developed guidance regarding verification of Standard Industrial Classification (SIC) codes to ensure a company qualifies to receive certain credits but rather relies on the customer's certification. We also identified two opportunities that have been reported in previous distributor audits. TVA is in the process of addressing these two findings, which include the (1) absence of a joint cost study being performed in over 20 years and (2) lack of an adequately defined process to document approval of credits.

What the OIG Recommends

We recommend the Group President, Strategy and External Relations (S&ER), work with LCUB to (1) remediate classification and metering issues, (2) comply with contract provisions related to customer contracts and allocation of joint costs, and (3) strengthen internal controls. In addition, the Group President, S&ER, should develop and provide guidance outlining the amount of verification required to ensure a customer meets the established SIC code criteria and thereby qualifies to receive certain credits.

Management's Comments

LCUB and TVA management agreed with and have or are taking actions to address the recommendations. See Appendix B for LCUB's complete response and Appendix C for TVA's complete response.

Auditor's Response

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

BACKGROUND

The Lenoir City Utilities Board (LCUB)[1] is a distributor for Tennessee Valley Authority (TVA) power based in Lenoir City, Tennessee, with revenues from electric sales of approximately $151 million in fiscal year (FY) 2009. TVA relies on distributors to self-report customer usage and subsequently the amount owed to TVA (Schedule 1). Customers are generally classified as residential, commercial, manufacturing, and lighting. Within these classes are various rate classifications based on the customer type and usage. Table 1 shows the customer mix for LCUB as of June 2009.

LCUB's Customer Mix as of June 2009

Customer Classification	Number of Customers	Revenue	Kilowatt Hours Sold
Residential 47,125		$77,836,267	825,316,128
General Power – 50 Kilowatt (kW) and Under (Commercial)	9,502	16,921,875	155,187,900
General Power – Over 50 kW (Commercial or Manufacturing)	944	55,172,835	610,133,385
Street and Athletic	40	371,457	4,061,520
Outdoor Lighting[2] 372		1,029,991	9,435,565
Unbilled Revenue		(809,735)	
Total	**57,983**	**$150,522,690**	**1,604,134,498**

Table 1

The distributors are required to establish control processes over customer setup, rate application, and measurement of usage to ensure accurate and complete reporting to TVA. LCUB, like many other distributors, outsources its billing and invoice processing to a third-party processor, Central Service Association (CSA). LCUB uses CSA systems to establish and set up new customers, input customer meter information, perform the monthly billing process, and execute customer account maintenance. Additionally, CSA provides LCUB with management reporting capabilities (e.g., exception reports). All other accounting and finance responsibilities are handled by LCUB, which has a Board of Directors providing oversight and a manager and accountant managing the daily activities. LCUB also operates nonelectric businesses that include gas, water, and sewer utilities.

1 The wholesale power contract is between the "City of Lenoir City, Tennessee," and TVA. The "Lenoir City Utilities Board," a department of the City of Lenoir City, manages and operates the electric, gas, water, and sewer utilities departments for the City. We will use "Lenoir City Utilities Board" rather than the "City of Lenoir City" in this report.

2 This customer count represents those customers who only have Outdoor Lighting services with LCUB. Another 5,183 customers had Outdoor Lighting services as well as other services with LCUB at June 30, 2009. The "Revenue" and "Kilowatt Hours Sold" include both Outdoor Lighting categories.

FINDINGS

Our review of LCUB found issues involving customer classification and metering that could impact (1) the proper reporting of electric sales and/or (2) nondiscrimination in providing power to members of the same rate class. In addition, we found LCUB had enough cash on hand to cover planned capital projects and provide a cash reserve of about 8 percent, which is within TVA's established guidelines for adequate cash reserves of 5 to 8 percent.

We also found improvements were needed to (1) comply with contract provisions regarding the establishment of written contracts with customers and allocation of certain joint costs between service departments and (2) strengthen the distributor's internal controls. Finally, we have identified certain opportunities to enhance TVA's oversight of the distributors.

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

As discussed on the following page, we identified customer classification and metering issues that could impact the proper reporting of electric sales. In addition, these issues could impact the ability to ensure nondiscrimination in providing power to members of the same rate class.[3] We were unable to estimate the monetary effect of these metering issues because customer demand information was not available. However, for the two customer classification items, the monetary effect on LCUB and TVA was not material. 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 Classification Issues

We found 102 customer accounts that were not classified properly. Of the 102 accounts, 7 were commercial customer accounts classified within the General Power Rate – Schedule GSA. The GSA schedule is divided into three

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

parts—Part 1, Part 2, and Part 3—based on electric usage and demand,[4] and these customer accounts were incorrectly assigned within the GSA schedule. The remaining 95 customer accounts were classified as residential, although they should have been classified under the GSA schedule. The monetary impact of the classification issues below would not be material to LCUB or TVA. Specifically, we found:

- Seven customer accounts were classified as GSA Part 1[5] instead of GSA Part 2. According to the GSA schedule, a customer should be classified as GSA Part 2 if (1) usage is over 15,000 kilowatt hours (kWh), (2) metered demand exceeds 50 kW, or (3) contract demand is greater than 50 kW. When a customer is moved to GSA Part 2, they must remain at that classification for 12 months after meeting the Part 2 criteria. These customers had metered demand over 50.01 kW at least one month during the audit period; therefore, the customer should have been classified as a GSA Part 2 for the next 12 months.

  Based on information provided by billing agency personnel, the CSA system used by LCUB did not automatically change a customer from GSA Part 1 to GSA Part 2 based on metered demand until after demand exceeds 50.499 kW rather than the 50 kW as stated under Part 2 of the GSA schedule. Two of these customer accounts were later automatically upgraded to GSA Part 2 by the billing system when the demand exceeded 50.499 kW or usage exceeded 15,000 kWh. The other five customer accounts did not have demand that exceeded 50.499 kW for the remainder of the audit period; therefore, the customer account was not automatically upgraded to GSA Part 2 by the billing system. In response to previous audits, CSA modified the billing system to correct this issue.

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

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

5 Under the General Power Rate – Schedule GSA adopted by LCUB, customers are classified based on the following requirements:

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

- Ninety-five customer accounts were classified as residential customers instead of GSA schedule customers. These accounts consisted of service to commercial businesses, churches, or other separately metered structures, such as barns, sheds, garages, pumps, pool houses, boat docks, gates, etc., which do not qualify as a single family dwelling. LCUB personnel stated work orders were initiated to have the accounts reclassified from residential to commercial (GSA schedule) during our audit.

Metering Issues
In addition to the customer classification issues, our review of billing agency data noted the following two issues related to metering of customer accounts at LCUB. We were unable to estimate the monetary effect because in some instances meters were not in place that would provide information to make the estimates. Specifically, we found:

- Four customer accounts classified as GSA Part 2 had energy usage in excess of 25,000 kWh but were not measured for demand.[6] 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 customer accounts would have exceeded 50 kW. Three additional accounts had usage in excess of 25,000 kWh during the audit period; however, LCUB has installed a demand meter at the location for two of these accounts, and service to the remaining account has been disconnected.
- Two customer accounts had zero usage readings for a time during the audit period. These customer accounts were identified as having a metering issue or a bad meter, which caused these readings. LCUB personnel stated they have replaced these meters and are working to back bill these customers.

USE OF ELECTRIC SYSTEM REVENUES

Under the TVA power contract, approved uses of revenues from electric system operations, including any surplus, are (1) operating expenses, (2) debt service, (3) tax equivalent payments, and (4) reasonable reserves for renewals, replacements, and contingencies. As discussed on the following page, we noted LCUB had enough cash on hand to cover planned capital projects and provide a cash reserve of about 8 percent, which is within TVA's established guidelines for adequate cash reserves of 5 to 8 percent.[7]

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6 On February 12, 2010, in response to a finding in a previous 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.

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

As of June 30, 2009, LCUB reported about $19.3 million in its cash and cash equivalent accounts. Table 2 shows information about major capital expenditures obtained from LCUB management.

LCUB's Planned Capital Expenditures for FY 2010

Capital Expenditure Plans	Project Cost
Upgrades and System Improvements	$625,000
Road Construction	$500,000
Distribution Plant	$3,000,000
Substation and Transmission	$4,160,000
Contracted Labor	$75,000
Transportation Equipment	$265,000
Information Technology	$154,700
Total Planned Capital Expenditures	**$8,779,700**

Table 2

When compared to LCUB's capital expenditure plans for FY 2010 , the balance in LCUB's cash accounts was enough to pay for these items and leave about $10.5 million as a reserve, as shown in Table 3. Table 3 also shows LCUB's cash ratio percentage was about 14 percent before accounting for planned capital expenditures and about 8 percent after accounting for them.

LCUB's Cash Accounts Compared to Planned Capital Expenditures

	Cash and Cash Equivalents	Planned Capital Expenditures	Reserve After Planned Capital Expenditures
FY 2009	$19,271,001	$8,779,700	$10,491,301
Cash Ratio Percentage	14.07%	7.68%	

Table 3

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

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

Cash on Hand Equivalent to an 8% Cash Ratio	Cash and Cash Equivalents[8] and Cash Ratio	Rate Increase[9]		
		Additional Revenue	Percent	Effective Date
$6,884,499	$14,276,947 (CR = 16.6%)	$1,648,137	1.78%	10/1/2005
$7,991,429	$13,647,685 (CR = 13.7%)	$4,254,528	4.58%	10/1/2006

Table 4

Discussions with LCUB management indicated their operating philosophy has become a more conservative, generally debt-averse approach than in the past.

CONTRACT COMPLIANCE ISSUES

We noted two areas where LCUB was not meeting the requirements of the power contract with TVA. Specifically, in the area of customer contracts we found (1) customers without a written contract and (2) certain joint costs were not allocated among service departments. Below is further discussion on these items.

Customer Contracts When Demand Exceeds Threshold

We found LCUB did not have customer contracts for all customers with demand above 1 megawatt (MW). Specifically, we found 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 reports, indicated the threshold of 50 kW for requiring customer contracts was too low. TVA management will recommend to the TVA Board that a new and higher threshold be established as part of the rate change process with the distributors.[10] In further discussions with TVA personnel, the proposed threshold for requiring a contract is 1 MW. We found six LCUB customer accounts with metered demand in excess of 1 MW without a contract. 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 and minimum bill.

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

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

10 When the rate change is put into effect, all retail customers above the new threshold will be expected to have executed contracts. Target completion date will coincide with the rate change efforts that are currently under way with the distributors and is expected to be in place by October 2010.

Allocation of Joint Costs
We noted one instance in which LCUB's accounting practices did not conform to the power contract with TVA. Under the power contract, the distributor is allowed to "use property and personnel jointly for the electric system and other operations, subject to agreement between Municipality and TVA as to appropriate allocations." The last joint cost study was performed in 1989 and addressed rental costs for office space occupied by the other service departments as follows:

> The electric department was to furnish utility, janitorial service, and maintain and operate the building, and that costs incurred thereby will be borne by the water[11] and gas departments and the electric system in proportions to their respective equities.

According to the 1989 joint cost study, the allocation percentages applicable to water and gas were about 6 percent and 4 percent, respectively. LCUB's service area has increased since 1989, and as a result, LCUB has updated the allocation percentages to more accurately allocate costs based on percentages of customers serviced by each department. The percentages are calculated annually, and during our audit period the total percentage for water and sewer was about 17 percent, and the percentage for gas was about 7 percent. Most joint costs were allocated to the other service departments based on these percentages. However, we noted all utilities and maintenance costs associated with the office buildings owned by the electric department were paid by the electric department even though other service departments occupied space in the office buildings. In addition, according to LCUB personnel, the other service departments do not pay rent for the space they occupy in the electric department's office buildings.

DISTRIBUTOR INTERNAL CONTROL ISSUES

We identified two areas where LCUB's internal controls could be strengthened. Specifically, we found improvements could be made with respect to (1) accuracy of contract demand data entered in the billing system and (2) developing policies to improve controls over charitable contributions.

Contract Demand in Billing Agency System
We noted two issues related to entering contract demand in the billing system. We identified four accounts where the contract demand per the contract did not agree with the contract demand entered into the billing system. Specifically, we found (1) three accounts had a contract demand amount in the system that was less than the contract demand per the contract, and (2) one account did not have a contract on file but had a contract demand amount entered in 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 both the monthly demand charge and the minimum bill amount.

[11] According to LCUB personnel, the water and sewer departments were combined and were reported as one department at this time.

Developing Policies to Improve Controls Over Charitable Contributions
We noted there were no formal policies at LCUB over charitable contributions. Specifically, we noted LCUB did not have written guidance for (1) the types of organizations eligible for contributions or (2) approval levels/limits for charitable contributions. LCUB personnel stated informal guidelines had been implemented after our audit period for allocating contribution costs to the service departments based on the service area benefitting from the contribution. Formalizing policies is a prudent business practice that will help the distributor ensure expenditures are properly controlled and are used for electric system purposes.

TVA OVERSIGHT OPPORTUNITIES

We found opportunities to enhance TVA's oversight of this distributor. We noted one new oversight opportunity in addition to two issues that have been reported in previous Office of the Inspector General (OIG) distributor reports. Specifically, we noted TVA has not:

- Required eligibility verification for customers receiving certain credits, such as the Small Manufacturing Credit (SMC) and the Enhanced Growth Credit (EGC). Currently, in order to receive these credits, the customer must complete an application form including the Standard Industrial Classification[12] (SIC) code applicable to their business. Only specific SIC codes qualify the customer to receive each type of credit, and the SIC code listed should be the code that represents the primary business activity at the location being billed rather than the SIC code applicable to the parent company's primary business. By signing the application form, the customer certifies all information is correct, including the SIC code listed for their company. However, neither TVA nor the distributor verifies the customer's SIC information is correct if the customer includes an SIC code for their primary business on the form. If the company does not know what SIC code is applicable to their primary business, the distributor and TVA Customer Service will assist the customer in determining the appropriate SIC code.

  According to TVA management, TVA's intent was to rely on the customer's certification.[13] We attempted to verify the SIC code for the seven accounts receiving the SMC credit at June 20, 2008, and the eight accounts receiving the SMC and EGC credits at June 30, 2009, by reviewing the SIC code(s) listed for each company in a federal and a commercial database.[14] We could not verify the SIC codes for three of these accounts using either database.

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[12] The SIC code consists of a standard series of four-digit codes created by the United States government in 1937 for categorizing business activities. In 1997, the use of SIC codes was replaced in most (but not all) capacities by a six-digit code called the North American Industry Classification System. http://www.investopedia.com/terms/s/sic_code.asp

[13] The forms include a clause stating substantial penalties, including repayment of any amounts over-credited to the customer, and terminating participation from the credit program could be enforced if the customer intentionally provides materially false information on the application.

[14] The federal database is the Environment Protection Agency Facility Registry System (at www.epa.gov/enviro/html/fii/fii_query_java.html), and the commercial database is Dun and Bradstreet information obtained from the Customer Relations group at TVA.

- Performed a joint cost study in over 20 years when the TVA Accountant's Reference Manual calls for one to be performed every three to four years or when major changes occur that affect joint operations.
- Adequately defined the process for granting the SMC to ensure proper documentation, including evidence of approval, is submitted and maintained.

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

RECOMMENDATIONS

We recommend the Group President, Strategy and External Relations (S&ER), work with LCUB to improve compliance with the contract and/or strengthen internal controls. Specifically, LCUB should:

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

   LCUB's Response – LCUB stated they are working with their billing provider to identify and resolve the classification issues. Planned completion date is September 2011. See Appendix B for LCUB's complete response.

   TVA Management's Comments – TVA agreed that electric service should be provided in accordance with the availability provisions of the rate schedules. See Appendix C for TVA's complete response.

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

2. In accordance with the TVA Guidance to Distributors on Demand Meters issued in February 2010, review all customers' usage greater than 25,000 kWh and either install demand meters, or document the reason a demand meter is not needed.

   LCUB's Response – LCUB stated demand meters have been installed at two of the three accounts that had usage in excess of 25,000 kWh during the audit period, and service to the remaining account has been disconnected. See Appendix B for LCUB's complete response.

   TVA Management's Comments – TVA agreed the distributor should review customer usage greater than 25,000 kWh and install demand meters if needed. See Appendix C for TVA's complete response.

   Auditor's Response – The OIG concurs with the actions taken by LCUB and no further action is necessary.

3. Implement a process to ensure all customers with demand greater than 1 MW have executed contracts with LCUB.

   LCUB's Response – LCUB stated effective April 2011, an executed contract will be required for all customers whose contract demand exceeds 1 MW. LCUB will begin working with customers whose contract demand exceeds 1 MW to verify all contracts are properly executed from this point forward. See Appendix B for LCUB's complete response.

   TVA Management's Comments – TVA agreed with the recommendation. See Appendix C for TVA's complete response.

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

4. Recover utilities and maintenance costs associated with office space occupied by the other service departments in the electric department's building using an allocation methodology approved by the LCUB Board or by charging rent.

   LCUB's Response – LCUB stated they have been notified their TVA Field Accountant will complete a Joint Cost Study within the next year. Target completion date is October 2011. See Appendix B for LCUB's complete response.

   TVA Management's Comments – TVA agreed there should be a proper allocation of costs associated with office space occupied by other service departments in the electric department buildings. See Appendix C for TVA's complete response.

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

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

   LCUB's Response – LCUB stated the four accounts have been corrected where the contract demand per the contract did not agree with the contract demand entered into the billing system. LCUB also stated a process to ensure demands coincide between the billing system and the customer contract will be drafted and implemented. Target completion date is June 30, 2011.[15] See Appendix B for LCUB's complete response.

   TVA Management's Comments – TVA agreed the distributor should have internal controls in place that will ensure data is correctly entered into the system. See Appendix C for TVA's complete response.

[15] LCUB's response in Appendix B stated the target date was June 30, 2010. However, LCUB notified the OIG that the target date should have been June 30, 2011.

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

6. Develop and implement policies and procedures pertaining to disbursing charitable contributions (e.g., allowable organizations, maximum amount that can be made at a time, maximum amount an organization may receive, maximum amount that can be made for the year, approval required, etc.).

   LCUB's Response – LCUB stated unwritten general guidelines currently exist but they will work toward a formal policy in the future. Target completion date is July 1, 2011. See Appendix B for LCUB's complete response.

   TVA Management's Comments – TVA agreed the distributor should develop and implement such policies and procedures. See Appendix C for TVA's complete response.

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

The Group President, S&ER, should:

7. Develop and provide guidance on verifying a customer's SIC and/or the North American Industry Classification System code to ensure only companies that meet the requirements receive the SMC and the EGC.

   TVA Management's Comments – TVA agreed and intends to send out guidance to all distributors on new policies on SIC codes that will go into effect as part of the rate change in April 2011. Target completion date for this action is April 2011. See Appendix C for TVA's complete response.

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

OBJECTIVE, SCOPE, AND METHODOLOGY

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

- Proper reporting of electric sales by customer class to facilitate proper revenue recognition and billing by TVA.
- Nondiscrimination in providing power to members of the same rate class.
- Use of revenues, including any surplus, for approved purposes, such as:
  - Operating expenses
  - Debt service
  - Tax equivalent payments
  - Reasonable reserves for renewals, replacements, and contingencies

To achieve our objective, we:

- Obtained LCUB electronic billing information from CSA for the audit period. The information was not complete because CSA does not maintain historical rate information for inactive customers. We used the information available to generate reports of exceptions related to classification and metering and conducted further review of documentation or discussed with management.
- Documented and tested the procedures and controls in place to ensure power usage (kWh) and demand (kW) reported to TVA on the Schedule 1, for purposes of billing the distributor, is complete and accurate.
- Determined through inquiry and review of documentation whether LCUB had any nonelectric, system-related business interests supported by electric system funds.
- Reviewed disbursements to determine if electric system funds were used for any items not allowed under the TVA power contract.
- Reviewed cash and cash equivalents in relation to planned capital expenditures and other business uses of cash.
- Used nonstatistical sampling methods as needed to perform the tests above.

The scope of the review was for the period July 2007 through June 2009. Fieldwork was conducted February 2010 through June 2010. This performance audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

September 3, 2010

Robert E. Martin, ET 3C-K

RESPONSE TO DRAFT AUDIT REPORT 2009-12594 – DISTRIBUTOR REVIEW OF LENOIR CITY UTILITIES BOARD

This is in response to your memorandum dated August 5, 2010.

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

A. Recommendations

1. Implement procedures to assist in identifying accounts that need to be reclassified as commercial when service starts or changes to a nonresidential type.

   - LCUB is working with their billing provider Central Service Association (CSA) to identify and resolve these classifications issues. Planned completion date is September 2011.

2. In accordance with the TVA Guidance to Distributors on Demand Meters issued in February 2010, review all customers' usage greater than 25,000 kWh and either install demand meters, or document the reason a demand meter is not needed.

   - LCUB has installed a demand meter at two of the three accounts that had usage in excess of 25,000 kWh during the audit period, and service to the remaining account has been disconnected.

3. Implement a process to ensure all customers with demand greater than 1MW have executed contracts with LCUB.

   - Effective April 2011, TVA Board has approved a change that requires an executed contract for all customers whose contract demand exceeds 1 MW. LCUB will begin working with customers whose contract demand exceeds 1 MW to verify all contracts are properly executed from this point forward.

4. Recover utilities and maintenance costs associated with office space occupied by other service departments in the electric department's building using an allocation methodology approved by the LCUB Board or by charging rent.

    - LCUB has been notified that our TVA Field Accountant will complete a Joint Cost Study within the next year. Target completion date is October 2011.

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

    - LCUB has corrected the four accounts where the contract demand per the contract did not agree with the contract demand entered into the billing system. LCUB will draft and implement a process to ensure demands coincide between the billing system and the customer contract. Target completion date is June 30, 2010.

6. Develop and implement policies and procedures pertaining to disbursing charitable contributions (e.g., allowable organizations, maximum amount that can be made at a time, maximum amount an organization may receive, maximum amount that can be made for the year, approval required, etc.).

    - LCUB currently has unwritten general guidelines on charitable donations but will work toward a formal policy in the future. Target completion date is July 1, 2011.

Sincerely,

M. Shannon Littleton
General Manager

September 3, 2010

Robert E. Martin, ET 3C-K

RESPONSE TO DRAFT AUDIT REPORT 2009-12594 – DISTRIBUTOR REVIEW OF LENOIR CITY UTILITIES BOARD (LCUB)

This is in response to your memorandum dated August 5, 2010.

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

Recommendations

1. Implement procedures to assist in identifying accounts that need to be reclassified as commercial when service starts or changes to a nonresidential type.
   - TVA management agrees that electric service should be provided in accordance with the availability provisions of the rate schedules.
   - **Actions taken or planned, and completion dates**: Distributor is working with their Billing provider Central Service Association (CSA) to resolve these classifications issues. Planned completion date is September 2011.

2. In accordance with the TVA Guidance to Distributors on Demand Meters issued in February 2010, review all customers' usage greater than 25,000 kWh and either install demand meters or document the reason a demand meter is not needed.
   - TVA management agrees that the distributor should review customer usage greater than 25,000 kWh and install demand meters if needed.
   - **Actions taken or planned, and completion dates**: The Distributor has installed a demand meter at two of the three accounts that usage in excess of 25,000 kWh during the audit period and service to the remaining account has been disconnected.

3. Implement a process to ensure all customers with demand greater than 1 MW have executed contracts with LCUB.
   - TVA management agrees with the recommendation,

- **Actions taken or planned, and completion dates**: Distributor will work with customers whose contract demand exceeds 1 MW to execute contracts. Planned completion date is September 2011.

4. Recover utilities and maintenance costs associated with office space occupied by other service departments in the electric department's building using an allocation methodology approved by the LCUB Board or by charging rent.

   - TVA management agrees that there should be a proper allocation of costs associated with office space occupied by other service departments in the electric department buildings.
   - **Actions planned or taken, and completion dates:** TVA's field accountants will complete this study within the next year and agree on any changes required. Target completion date is October 2011.

5. Implement a process to ensure all customers with contracts have the appropriate contract demand entered into the billing system and the contract demand in the system agree with the customer's contract.
   - TVA management agrees that Distributor should have internal controls in place that will ensure data is correctly entered into the system.
   - **Actions taken or planned, and completion dates**: Distributor has corrected the four accounts where the contract demand per the contract did not agree with the contract demand entered into the billing system. Distributor will draft and implement a process to ensure demands coincide between the billing system and the customer contract. Target completion date is September 2010.

6. Develop and implement policies and procedures pertaining to disbursing charitable contributions (e.g. allowable organizations, maximum amount that can be made at a time, maximum amount an organization may receive, maximum amount that can be made for the year, approval required, etc.
   - TVA management agrees that the Distributor should develop and implement such policies and procedures.
   - **Actions taken or planned, and completion dates**: Distributor currently has unwritten general guidelines on charitable donations but will work toward a formal policy in the future. Target completion date is September 2011.

The Group President S&ER, should:

7. Develop and provide guidance on verifying a customer's SIC and/or the North American Industry Classification System code to ensure only companies that meet the requirements receive the SMC and the EGC.
   - TVA management intends to send out guidance to all distributors on new policies on SIC codes that will go into effect as part of the rate change in April 2011. The target completion date for this is April 2011.

Kimberly S. Greene

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

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