



**Memorandum from the Office of the Inspector General**

March 22, 2012

Joseph J. Hoagland, WT 7B-K

**REQUEST FOR FINAL ACTION – AUDIT 2010-13659 – DISTRIBUTOR AUDIT OF  
MERIWETHER LEWIS ELECTRIC 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 at (865) 633-7373 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

MMN:HAC  
Attachment  
cc (Attachment):

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OIG File No. 2010-13659



Office of the Inspector General

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# *Audit Report*

To the Senior Vice President,  
Policy and Oversight

# **DISTRIBUTOR AUDIT OF MERIWETHER LEWIS ELECTRIC COOPERATIVE**

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Audit Team

Melissa M. Neusel  
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Audit 2010-13659

March 22, 2012

## **ACRONYMS AND ABBREVIATIONS**

FY	Fiscal Year
kW	Kilowatt
kWh	Kilowatt Hours
MLEC	Meriwether Lewis Electric Cooperative
MW	Megawatt
OIG	Office of the Inspector General
TVA	Tennessee Valley Authority

## **TABLE OF CONTENTS**

EXECUTIVE SUMMARY .....	i
BACKGROUND.....	1
FINDINGS .....	3
USE OF ELECTRIC REVENUE FOR UNAPPROVED PURPOSES.....	4
IMPROPER REPORTING OF ELECTRIC SALES AND/OR POTENTIAL DISCRIMINATION IN PROVIDING POWER TO CUSTOMERS.....	5
OTHER ISSUES.....	8
TVA OVERSIGHT OPPORTUNITIES .....	9
RECOMMENDATIONS .....	9

## **APPENDICES**

- A. OBJECTIVE, SCOPE, AND METHODOLOGY
- B. LETTER DATED MARCH 9, 2012, FROM HAL WOMBLE TO DAVID P. WHEELER
- C. MEMORANDUM DATED MARCH 6, 2012, FROM CYNTHIA L. HERRON TO DAVID P. WHEELER



# Audit 2010-13659 – Distributor Audit of Meriwether Lewis Electric Cooperative

## EXECUTIVE SUMMARY

### Why the OIG Did This Audit

In 2002, the Tennessee Valley Authority's (TVA) Board of Directors approved and made available to distributors six wholesale power contract flexibility options. One of the options terminated TVA's contract authority and obligations regarding distributors' retail rates. Four distributors (Meriwether Lewis Electric Cooperative [MLEC], Knoxville Utilities Board, Memphis Light, Gas and Water, and Scottsboro Electric Power Board) selected this option. Although each of these four distributors has the authority to determine the retail rates it will charge to its customers with limited or no oversight by TVA, the TVA Board did not relinquish its responsibility to ensure (1) the power purchased is sold and distributed to the ultimate consumer without discrimination among consumers of the same class, and (2) no discriminatory rate, rebate, or other special concession will be made or given to any consumer.

The supplemental agreement between TVA and MLEC became effective in 2004. As part of our annual audit plan, the OIG (Office of the Inspector General) audited the electric system of MLEC, a distributor based in Centerville, Tennessee, for compliance with the TVA power contract 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, MLEC provided power to approximately 35,000 customers resulting in electric sales revenue of approximately \$69 million to MLEC. At June 30, 2010, MLEC had a 5.17 percent cash ratio before considering planned FY 2011 capital expenditures, which is within TVA's established guidelines for adequate cash ratios of 5 to 8 percent.

### What the OIG Found

MLEC was not in compliance with one of the key contract provisions but generally complied with the other two provisions. Additionally, we identified a few other minor issues regarding MLEC's customer contract documentation and internal controls.

- Key Contract Provisions

MLEC was not in compliance with the current contract provision regarding the use of electric revenue for approved purposes. Specifically, we found MLEC:

1. Pledged electric funds to guarantee United States Department of Agriculture Rural Development (Rural Development) loans to its customers.
2. Disbursed electric funds for economic development in FYs 2009 and 2010 and included amounts for economic development in the FY 2010 capital budget.

TVA management has stated they are planning to recommend the TVA Board formally approve these uses of electric revenues. However, if this approval is not granted, we consider these to be noncompliance issues that should be discontinued.



# Audit 2010-13659 – Distributor Audit of Meriwether Lewis Electric Cooperative

## EXECUTIVE SUMMARY

Although MLEC was generally in compliance with the other two key contract provisions (proper reporting of electric sales and nondiscrimination in providing power), we noted the following: (1) energy and demand amounts had been reported incorrectly to TVA within two rate classifications and (2) a few customer misclassifications.

- Other Issues

MLEC's policies required customer contracts be obtained for accounts that exceed certain power demand thresholds. MLEC could not provide contract documentation for one of the customer's accounts we tested. We also found MLEC could strengthen its internal controls over documentation of the MLEC Board of Directors' formal approval of changes to retail rates and demand threshold criteria.

We also identified two areas where TVA's oversight of distributors could be enhanced. The issues, addressing (1) discontinuing the practice of allowing distributors to pledge electric system funds as guarantees for customer economic development loans with Rural Development and communicating this to all affected distributors and (2) the lack of guidance related to permitted expenditures, have been reported in previous OIG distributor audit reports, and TVA has agreed to take corrective action on these issues.

### What the OIG Recommends

We make 6 specific recommendations in this report that require MLEC action and recommend TVA's Senior Vice President, Policy and Oversight, work with MLEC to resolve them. These recommendations generally relate to (1) complying with power contract provisions, (2) remediating classification issues, and (3) strengthening internal controls.

We also make 1 recommendation to TVA. Specifically, TVA's Senior Vice President, Policy and Oversight, should determine any amounts due to TVA associated with accounts that should have been reported as GSA Part 2 and adjust invoices appropriately.

### MLEC Comments

MLEC did not provide comments to address the specific findings and recommendations in our draft audit report. Instead, in its response to our draft report, MLEC stated it objected to the OIG audit for various reasons, which include:

- MLEC had filed volumes of financial reports to TVA within the 73 year unbroken record of purchasing power from the Agency.
- An audited annual report was completed for 2011.
- MLEC files significant reporting to the United States Department of Agriculture's Rural Utilities Service, which had just completed its own audit of MLEC.



## Audit 2010-13659 – Distributor Audit of Meriwether Lewis Electric Cooperative

### EXECUTIVE SUMMARY

- MLEC is TVA's only cooperative distributor not subject to retail rate regulation by the Agency by virtue of its current wholesale power contract.

MLEC further stated it had complied with the OIG's repeated request for information because the MLEC Board of Directors did not want to appear to have anything to hide. However, MLEC stated it maintains the OIG has no standing whatsoever to audit MLEC's retail operations, and the TVA relationship ends at the wholesale delivery point.

See Appendix B for MLEC's complete response.

#### Auditor's Response to MLEC's Comments

While we appreciate MLEC's objections to our audit, we respectfully disagree. TVA's power contract with MLEC specifically provides for the duly authorized agents of TVA to have free access at all reasonable times to all books and records relating to electric system operations. Although MLEC is no longer subject to retail rate regulation by TVA, the 2004 agreement between TVA and MLEC did not release MLEC from all other provisions of the original power contract, which include (1) proper reporting of electric sales, (2) nondiscrimination in providing power, and (3) use of electric revenue for approved purposes.

#### TVA Management's Comments

TVA management generally agreed with our recommendations except for the recommendation regarding the proper accounting for economic development expenditures. Also, in response to a recommendation we made regarding the formal documentation of decisions and approvals by the MLEC Board related to resale rate components and amounts, TVA management stated they currently have no contract mechanism to mandate the recommended requirements related to MLEC's resale rates except with respect to enforcing the nondiscrimination requirement.

See Appendix C for TVA's complete response.

#### Auditor's Response to TVA Management's Comments

As discussed in detail in the accompanying report, we disagree with TVA management's comments regarding MLEC's classification of economic development expenditures as operating expenses instead of nonoperating expenses. Also, TVA will not be able to adequately enforce the power contracts nondiscrimination requirement unless MLEC maintains documentation regarding its retail rate components and amounts (i.e., energy usage and demand thresholds, amounts to charge, etc.). Such documentation is necessary to verify the rates charged to end users are correct and nondiscriminatory.

## **BACKGROUND**

Meriwether Lewis Electric Cooperative (MLEC) is a distributor for Tennessee Valley Authority (TVA) power based in Centerville, Tennessee, with revenues from electric sales to end use customers of approximately \$69 million in fiscal year (FY) 2010. Prior to April 1, 2011,<sup>1</sup> 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 MLEC as of June 2010.

**MLEC's Customer Mix as of June 2010**

<b>Customer Classification</b>	<b>Number of Customers</b>	<b>Revenue</b>	<b>Kilowatt Hours Sold</b>
Residential	29,071	\$40,808,777	432,021,272
General Power – 50 Kilowatt (kW) and Under (Commercial)	4,965	8,283,716	67,867,083
General Power – Over 50 kW (Commercial or Manufacturing)	346	19,056,277	227,296,925
Street and Athletic	58	336,320	3,029,147
Outdoor Lighting <sup>2</sup>	210	926,691	9,976,298
<b>Total</b>	<b>34,650</b>	<b>\$69,411,781</b>	<b>740,190,725</b>

**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. MLEC, like many other distributors, outsourced its billing to a third-party processor. MLEC used R & R Support systems to establish and set up new customers, input customer meter information, perform the monthly billing process, and maintain customer account information. Additionally, R & R Support provided MLEC with management reporting capabilities (e.g., exception reports) designed to ensure the accuracy and completeness of the customer invoice and the Schedule 1 provided to TVA. Invoice processing was outsourced to a third party, Total Billing. All other accounting and finance responsibilities are handled by MLEC, which has a 13-member Board of Directors who provide oversight and a President and Chief Executive Officer and management team who manage the daily activities.

<sup>1</sup> 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.

<sup>2</sup> The "Number of Customers" represents those customers who only have Outdoor Lighting accounts at June 30, 2010. In addition, another 9,597 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.

### Granting of Authority to Set Retail Rates

In 2002, TVA's Board approved and made available to distributors six wholesale power contract flexibility options. One of the options terminated TVA's contract authority and obligations regarding distributors' retail rates. In 2004, MLEC and TVA agreed to a wholesale power contract supplement that granted MLEC authority to set its own retail rates. Three other distributors, Knoxville Utilities Board, Memphis Light, Gas and Water, and Scottsboro Electric Power Board, have also been granted this authority by TVA. As a result, these four distributors have the authority to determine the retail rates charged to their customers with no or limited oversight by TVA. The TVA Board, however, did not relinquish the responsibility to ensure (1) the power purchased is sold and distributed to the ultimate consumer without discrimination among consumers of the same class, and (2) no discriminatory rate, rebate, or other special concession will be made or given to any consumer. The 2004 supplemental agreement with MLEC did not specifically state why the authority to determine the retail rates charged to customers with no or limited oversight by TVA was granted to MLEC. However, the supplemental agreements with Scottsboro, Knoxville, and Memphis, state the option was granted (1) because the electric utility industry was undergoing changes and restructuring and (2) to prepare for the prospect of legislation further altering the industry and the relationship between TVA and its distributors.

### Cash Position and Rate Changes

As of June 30, 2010, MLEC had a 5.17 percent cash ratio<sup>3</sup> before considering planned FY 2011 capital expenditures, which is within TVA's established guidelines for adequate cash reserve ratios of 5 to 8 percent. MLEC had \$11,808,291 in planned capital expenditures for FY 2011 and stated their preference was to pay for as much of these expenditures as possible from cash reserves, which was \$3,307,595 at June 30, 2010. MLEC also had \$15 million in Rural Utilities Service loans available to finance capital expenditures, which would provide full coverage of the planned capital expenditures. As of July 2011, MLEC had not exercised any portion of the loan.

According to MLEC records, from FYs 2006 to 2010, MLEC had rate increases in 2005, 2006, 2008, and 2009 and one rate decrease in 2006. Table 2, as shown on the following page, shows the rate increases/decreases enacted by MLEC and the cash position and cash ratio at June 30 prior to the effective date of the rate change.

<sup>3</sup> TVA reviews the cash ratios of distributors as part of its regulatory rate review function. Cash ratio is calculated as follows: 
$$\frac{\text{Cash + Cash Equivalents}}{\text{Total Variable Expenses (Operations and Maintenance + Purchased Power)}}$$

### MLEC's Rate Changes, Cash Position, and Cash Ratio

Cash on Hand Equivalent to an 8% Cash Ratio	Cash and Cash Equivalents <sup>4</sup> and Cash Ratio (CR)	Rate Increase/Decrease <sup>5</sup>	
		Percent	Effective Date
\$3,966,554	\$785,680 (CR = 1.58%)	7.8%	10/01/2005
\$3,966,554	\$785,680 (CR = 1.58%)	8.0%	4/01/2006
\$4,388,857	\$3,392,026 (CR = 6.18%)	(4.5)%	10/01/2006
\$4,950,517	\$7,430,659 (CR = 12.01%)	20.0%	10/01/2008
\$5,577,354	\$4,120,946 (CR = 5.91%)	9.0%	10/01/2009

Table 2

Discussions with MLEC management indicated its operating philosophy is generally conservative. MLEC prefers to keep enough cash on hand to meet the next month's TVA power invoice, and any cash on hand beyond this amount is invested in Cooperative Finance Corporation commercial paper.

## **FINDINGS**

Our audit of TVA's power contract with MLEC determined:

- MLEC was not in compliance with the key contract provision regarding the use of electric revenue for approved purposes. Although MLEC generally complied with the other two key provisions, we noted issues regarding (1) incorrect reporting to TVA of energy and demand amounts within two rate classifications and (2) a few customer misclassifications.
- MLEC could strengthen internal controls over documentation of customer contracts and MLEC Board of Directors' formal approval of changes to retail rates and demand threshold criteria.
- TVA's oversight of distributors could be enhanced.

The following provides a detailed discussion of our findings.

<sup>4</sup> The cash and cash equivalents and cash ratio were computed based on information from MLEC's annual report as of June 30 prior to the effective date of the rate change.

<sup>5</sup> This rate increase/decrease information was provided to the Office of the Inspector General by MLEC management. In the documentation received, some rates indicate whether the rate increase/decrease did or did not include TVA's Fuel Cost Adjustment and others did not. Because MLEC is self-regulated, TVA does not have control over the rate increases/decreases enacted by the distributor.

## USE OF ELECTRIC REVENUE FOR UNAPPROVED PURPOSES

Our review of MLEC's use of revenue found MLEC had (1) pledged \$647,500 in electric system funds to guarantee United States Department of Agriculture Rural Development<sup>6</sup> (Rural Development) loans to customers, and (2) disbursed \$143,518 in FY 2009 and 2010 for economic development and community involvement and included \$33,500 for economic development and community involvement in its FY 2010 budgets.

As discussed below, these uses of electric funds fall outside the current power contract provisions for approved uses. More specifically, 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, lending, pledging, or otherwise diverting electric system funds and revenues to nonelectric purposes.

- **Pledging Of Electric System Funds Not Allowed by the Power Contract**

At June 30, 2010, MLEC had pledged approximately \$647,500 in electric system funds to guarantee Rural Development loans to customers. This amount included approximately \$400,000 for grant funds loaned to customers and \$247,500 for two intermediary loans MLEC would be obligated to pay to Rural Development should the customers default. We estimated the total electric funds at risk<sup>7</sup> at June 30, 2010 would reduce the cash ratio from 5.17 percent to 4.16 percent before planned FY 2011 capital expenditures.

- **Disbursing Electric Funds for Economic Development Not Allowed by the Power Contract**

MLEC assists the counties and communities in the service area by budgeting for and disbursing electric funds to support economic development. MLEC's FY 2010 budget included a total of \$33,500 for economic development and community involvement, and according to MLEC personnel, the funds are disbursed only upon request. MLEC's trial balances for the audit period indicate total disbursements were \$75,200 in FY 2009 and \$68,318 in FY 2010 for economic development and community involvement and posted as operating expenses.

In addition to being an unallowable use of funds per the power contract, under section 1(b) of the contract "Schedule of Terms and Conditions," MLEC is required to keep the electric system general books of accounts in accordance

<sup>6</sup> Rural Development is a division of the United States Department of Agriculture that administers the Rural Economic Development Loan and Grant Program.

<sup>7</sup> 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.

with the Federal Energy Regulatory Commission Uniform System of Accounts. According to Federal Energy Regulatory Commission, payments or donations for charitable, social or community welfare purposes are nonoperating expenses and should be recorded in Account 426.1 (Donations). MLEC currently records these expenditures in operating expense accounts 9083, 9089, and 9090.

In response to similar findings in a previous audit, TVA management agreed these practices are not expressly allowed under the power contract. However, management stated they plan to recommend the TVA Board formally approve a use of revenues policy, which would expressly approve distributors (1) participation in the United States Department of Agriculture Rural Economic Development and Grant Program and (2) use of electric system revenues for economic development. If the TVA Board approves this policy, this practice may no longer be a violation of the power contract provisions. However, if this approval is not granted, we consider these to be noncompliance issues that should be discontinued.

## **IMPROPER REPORTING OF ELECTRIC SALES AND POTENTIAL DISCRIMINATION IN PROVIDING POWER TO CUSTOMERS**

During our review of MLEC's billing data, we identified three customer classification issues 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.<sup>8</sup> The specific issues we found were:

- Energy (kWh) and demand<sup>9</sup> (kW) amounts were reported to TVA using retail schedule rather than wholesale schedule criteria for certain accounts within two General Power Rate – Schedule GSA rate classifications.
- Commercial accounts were misclassified within the GSA rate classifications.
- Commercial accounts were misclassified as residential.

<sup>8</sup> Section 2 Resale Rates subsection (a) of the power contract between TVA and MLEC, dated March 31, 2004, 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."

<sup>9</sup> 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."

### **Improper Reporting Of Electric Sales Using Retail Criteria**

Our review of MLEC billing data identified 104 commercial accounts potentially misclassified as GSA Part 1 rather than GSA Part 2 based on the energy and demand threshold criteria in the Wholesale General Power Rate – Schedule.<sup>10</sup> Upon investigation we found this was a result of MLEC reporting accounts to TVA based on their retail rate classification rather than the classification criteria of the Wholesale Rate Schedule.

As previously stated, under the 2004 supplemental agreement, MLEC was granted authority to determine the components of its retail rates (i.e., energy usage and demand thresholds, amounts to charge, etc.). In July 2007, the MLEC Board formally approved changing the criteria for classifying GSA Part 1 and GSA Part 2 accounts using a 12-month rolling average of energy usage rather than only the current month's energy usage. During our site visit, MLEC personnel stated the demand threshold was similarly changed.

Although MLEC was granted authority to change their retail rates and components, the revised wholesale power contract did not change the Schedule 1 reporting requirements (i.e., usage and demand for the various rate classifications.) Therefore, demand should have been reported on the monthly Schedule 1 for all accounts meeting the wholesale GSA Part 2 schedule criteria.

We could not determine the total monetary effect for this systemic issue because historical information for rate classifications was not maintained in MLEC's billing system. We also could not tell if an account had been classified at a different rate earlier in the audit period because the account's classification as of June 2010 was listed for every month of the audit period in the billing data. However, because of the similarity in the GSA Part 1 and Part 2 pricing structure and the number of misclassified accounts, the monetary impact to TVA and MLEC would not be significant.

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<sup>10</sup> Under the Wholesale General Power Rate – Schedule GSA, customers are classified based on the following requirements:

- GSA Part 1 – If (a) the higher of (i) the customer's currently effective contract demand, if any, or (ii) its highest billing demand during the latest 12-month period is not more than 50 kW and (b) the 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.

**Accounts Misclassified Within Retail GSA Schedule**

As previously mentioned, MLEC changed the energy and demand threshold criteria for retail GSA Part 2 accounts. Based on the new threshold criteria, we found 9 accounts out of 109 (8.3 percent) initially identified as potentially misclassified were incorrectly assigned within the 3 parts of the retail GSA schedule during a portion of the audit period. Of these 9 accounts:

- 5 accounts should have been classified as retail GSA Part 2 rather than GSA Part 1 based on the 12-month rolling average for exceeding 15,000 kWh and/or 50 kW.
- 2 accounts should have been classified as retail GSA Part 3 rather than a GSA Part 2 based on actual demand or contract demand.
- 2 accounts should have been classified as retail GSA Part 2 rather than GSA Part 3 based on a previous actual demand or contract demand.

It should be noted that MLEC's billing system did not automatically reclassify accounts based on energy or demand criteria. The billing system generated exception report(s) indicating accounts that exceeded or dropped below the threshold criteria. MLEC personnel reviewed the exception reports and manually reclassified accounts. The low percentage of misclassified accounts indicates MLEC personnel review and reclassify accounts on a consistent basis. The monetary effect of the misclassifications identified would not be significant to MLEC or TVA. MLEC has corrected all but one of the accounts, and it is being reviewed.

**Accounts Misclassified as Residential**

We found 744 customer accounts that appeared to be improperly classified as residential based on the account name. At our request, MLEC reviewed these accounts and determined 7 accounts (0.94 percent) classified under the Residential Rate – Schedule RS<sup>11</sup> should have been classified under the commercial GSA schedule. These accounts consisted of service to a commercial business or other separately metered structures, such as shops, offices, cell towers, etc., which do not qualify as a single-family dwelling. The monetary impact of these misclassifications would not be significant to MLEC or TVA. MLEC personnel indicated the accounts will be reclassified as appropriate.

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<sup>11</sup> 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."

## OTHER ISSUES

We identified two areas where MLEC could strengthen its internal controls over documentation:

- MLEC's policies required customer contracts be obtained for accounts that exceed certain power demand thresholds. MLEC could not provide contract documentation for one of the customer's accounts we tested.
- The MLEC Board of Directors' formal approval of changes to retail rates and demand threshold criteria was not documented in the minutes.

### **Customer Contract Not On File**

The original power contract required all customers who exceed 50 kW per month to sign a formal contract. In 2004, MLEC was granted authority to determine the components of its retail rates (i.e., energy usage and demand thresholds, amounts to charge, etc.) and decided to remain with the 50 kW requirement for customer contracts. 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 in addition to determining the correct rate classification; therefore, having the required contract documentation is necessary to support the classification assigned and the rates charged.

To determine compliance with MLEC's policy, we selected a judgmental sample of 34 customer accounts from the 292 accounts that should have a contract. MLEC did not have a customer contract on file for 1 of the 34 sampled customer accounts (2.94 percent). MLEC personnel subsequently informed us a review of accounts that should have a contract had been performed in order to ensure contracts were in place and up to date.

### **MLEC Board Approval Not Formally Documented**

MLEC could not provide documentation indicating the MLEC Board formally approved (1) increasing the FY 2010 retail rates and (2) changing the demand threshold criteria for the retail GSA Part 2 rate classification.

The August 2009 Board Meeting Minutes state the MLEC Board was informed TVA had notified distributors of a wholesale base increase that would be about 9 percent and become effective October 1, 2009. However, unlike the October 2008 retail rate increase that was formally approved by the MLEC Board and documented in the Board Minutes, the August 2009 Board Minutes do not indicate the MLEC Board formally approved to pass the 2009 rate increase through to the end use customers. MLEC's retail rates were increased effective October 1, 2009.

As mentioned previously, after MLEC was granted the authority to determine and/or modify components of its retail rates via the 2004 supplement, the MLEC Board formally approved to change the energy threshold requirement for GSA Part 2 accounts in July 2007. We were informed the demand requirement for GSA Part 2 accounts was similarly changed; however, we were not able to find documentation indicating the MLEC Board formally approved changing the demand threshold requirement. We verified both the energy and demand changes were implemented in the billing system. All MLEC Board approvals should be documented to provide evidence supporting the approval.

## **TVA OVERSIGHT OPPORTUNITIES**

We identified two areas where TVA's oversight of distributors could be enhanced. The issues, addressing (1) discontinuing the practice of allowing distributors to pledge electric system funds as guarantees for customer economic development loans with Rural Development and communicating this to all affected distributors and (2) the lack of guidance related to permitted expenditures, have been reported in previous Office of the Inspector General (OIG) distributor audit reports, and TVA has agreed to take corrective action on these issues.

Full discussion of the previously reported issues and TVA's planned actions can be found in prior OIG distributor audit reports<sup>12</sup> on our Web site, [www.oig.tva.gov](http://www.oig.tva.gov).

## **RECOMMENDATIONS**

We make 6 specific recommendations in this report that require MLEC action and recommend TVA's Senior Vice President, Policy and Oversight, work with MLEC to resolve them. These recommendations generally relate to (1) complying with power contract provisions, (2) remediating classification issues, and (3) strengthening internal controls. Specifically, MLEC should:<sup>13</sup>

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

**TVA Management's Comments** – TVA management agreed with the recommendation and stated they plan to recommend the TVA Board formally approve a use of revenues policy, which expressly approves distributor participation in the United States Department of Agriculture Rural Economic Development Loan and Grant Program. See Appendix C for TVA's complete response.

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<sup>12</sup> November 16, 2011 – Distributor Audit of Volunteer Energy Cooperative 2010-13285, May 15, 2009 – Distributor Review: Lewisburg Electric System 2008-12040.

<sup>13</sup> As discussed in the executive summary, MLEC did not provide comments to address the specific findings and recommendations. Instead, MLEC's response to our draft report only discussed its objections to the OIG audit. See Appendix B for MLEC's complete response.

**Auditor's Response** – As stated in the body of the report, if the TVA Board approves this use of revenues policy, this practice may no longer be a violation of the power contract provisions. However, if this approval is not granted, we consider these to be noncompliance issues that should be discontinued.

2. Discontinue or obtain TVA approval for the practice of using electric funds for economic development.

**TVA Management's Comments** – TVA management agreed with the recommendation and stated it plans to recommend the TVA Board formally approve a use of revenues policy, which approves using electric funds for economic development expenses under certain circumstances. See Appendix C for TVA's complete response.

**Auditor's Response** – As stated in the body of the report, if the TVA Board approves this use of revenues policy, this practice may no longer be a violation of the power contract provisions. However, if this approval is not granted, we consider these to be noncompliance issues that should be discontinued.

3. Properly account for economic development expenditures as nonoperating expenses in Account 426.1 (Donations).

**TVA Management's Comments** – TVA management disagreed with the recommendation and stated an account provided for under Section 426.1 (Donations) of the Federal Energy Regulatory Commission should only include “. . . payments or donations for charitable, social or community welfare purposes.” TVA management also stated it does not view reasonable economic development expenditures as significantly serving welfare purposes; rather, TVA views such economic development expenditures as providing a benefit to the electric system by way of promoting or retaining the use of utility services by present and prospective customers. Accordingly, TVA management views accounts provided for under Section 912 (Demonstrating and Selling Expenses) as the most proper account to account for economic development expenditures and will discuss classifying reasonable economic development expenditures in Account 912 with MLEC. See Appendix C for TVA's complete response.

**Auditor's Response** – One of the responsibilities mandated to TVA via the TVA Act is economic development in the valley. Consequently, TVA has specific organizations dedicated to economic development, and costs associated with economic development are considered routine, ongoing, and normal day-to-day expenses that are necessary for conducting business (operating expenses). However, the distributors do not have this same mandated responsibility per the power contract. Distributors' electric funds spent for economic development are not routine, ongoing, and normal

day-to-day expenses, and therefore are nonoperating rather than operating expenses.

As previously mentioned, TVA management plans to recommend the TVA Board formally approve a use of revenues policy, which expressly approves distributors using electric funds for economic development expenses under certain circumstances. However, the OIG maintains that distributors' expenditures for economic development are nonoperating expenses that should be reported as "Donations" in Account 426.1 rather than reported as "Demonstrating and Selling Expenses" in operating expense Account 912. If economic expenditures were truly operating expenses for distributors, TVA management would have no need to request TVA Board approval for these expenditures because operating expenses are expressly allowed as uses of revenue under the power contract.

4. Review commercial and residential accounts identified as misclassified and correct misclassifications as appropriate.

**TVA Management's Comments** – TVA management agreed electric service should be provided in accordance with the availability provisions of the applicable rate schedule. TVA management also stated MLEC will review the commercial and residential accounts that are misclassified and reclassify accounts to the appropriate rate schedule. See Appendix C for TVA's complete response.

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

5. Continue to review customer accounts, and obtain and maintain properly executed effective customer contracts for all customers with demand in excess of 50 KW in accordance with MLEC policy.

**TVA Management's Comments** – TVA management agreed MLEC should execute retail contracts for customers with contract demand greater than 50 kW in accordance with the written contract requirement of the rate schedule. TVA management will discuss obtaining executed contracts for customers with demand in excess of 50 kW with MLEC. See Appendix C for TVA's complete response.

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

6. Formally document all decisions and approvals by the MLEC Board related to resale rate components and amounts (i.e., energy usage and demand thresholds, rate increases or decreases, amounts to charge, etc.) in the future.

**TVA Management's Comments** – TVA management agreed such documentation is good business practice and encouraged such documentation. However, TVA management stated the March 2004

“flexibility agreement” eliminated the Power Contract provisions under which TVA previously regulated the design and level of MLEC’s resale rates and related processes. TVA management also stated that it currently has no contract mechanism by which to mandate the recommended requirements related to MLEC’s resale rates except with respect to enforcing the nondiscrimination requirement of the Power Contract and TVA Act. See Appendix C for TVA’s complete response.

**Auditor’s Response** – Because the authority to design and approve the retail rate components and amounts was granted to MLEC, in order for TVA to verify the rates charged to end users are correct and nondiscriminatory, it is necessary for MLEC to (1) completely document all retail rate components and amounts (i.e., energy usage and demand thresholds, amounts to charge, etc.), (2) document the formal approval of those retail rate components and amounts, and (3) retain the formally approved documentation of those retail rate components and amounts.

TVA’s Senior Vice President, Policy and Oversight, should:

7. Work with MLEC to determine any amounts due to TVA associated with accounts that should have been reported as GSA Part 2 and adjust invoices appropriately.

**TVA Management’s Comments** – TVA management agreed with the recommendation and will work with MLEC to determine if funds may be owed to TVA as a result of misclassification. TVA management stated it understands some of the data to calculate this amount may not be readily available and so the cost benefit of trying to estimate this data as well as the accuracy of the data obtained will also be evaluated before moving forward. If TVA is able to determine these amounts, invoices will be adjusted appropriately. See Appendix C for TVA’s complete response.

**Auditor’s Response** – The OIG concurs with TVA’s planned actions.

## OBJECTIVE, SCOPE, AND METHODOLOGY

This audit was initiated as a part of our annual workplan. The objective was to determine compliance with key provisions of the power contract between the Tennessee Valley Authority (TVA) and Meriwether Lewis Electric Cooperative (MLEC) and not to assess the distributor's or TVA's system of internal controls. Therefore, controls associated with contract provisions listed below were not tested as part of this audit. The key contract provisions include:

- 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 and created a database for use in performing analytical testing. 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 the billing 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.
- We selected the following judgmental sample (based on contract demand values and their relation to TVA requirements and stricter guidelines adopted by MLEC) to review MLEC's customer contracts and supporting documentation for the 292 accounts with contract demand equal to or greater than 50 kW, as shown in Table 1.

Criteria	Number Selected	Comment	Percent of Population
Accounts with contract demand > = 1 MW (TVA's requirement)	10	All accounts meeting the TVA criteria were selected.	3.4%
Accounts with contract demand > = 50 kW (MLEC's requirement)	24	Each account had a different contract demand amount.	8.2%
<b>Total</b>	<b>34</b>		<b>11.6%</b>

Table 1

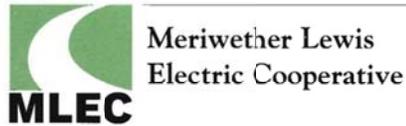
## **OBJECTIVE, SCOPE, AND METHODOLOGY (cont.)**

- Determined through inquiry and review of documentation whether MLEC 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.

When evaluating results of our audit work we used both qualitative and quantitative factors when considering the significance of an item. For the purposes of this audit the quantitative factor(s) to be considered in determining an item's significance were:

- 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 \$1,627,973.92, 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 July through October 2011 and included visiting the distributor's corporate office in Centerville, 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.



Your Touchstone Energy® Cooperative 

March 9, 2012

Mr. David Wheeler  
Office of Inspector General  
400 Summit Hill Drive  
Knoxville, TN 37902-1401

Subject: Response To OIG's Audit of MLEC

Dear Mr. Wheeler:

This is in response to OIG's request for a response to the above captioned document.

Meriwether Lewis Electric Cooperative, Inc. ("MLEC") objected to the OIG audit (sic) altogether for many reasons:

1. MLEC has filed volumes of financial reports to TVA within the 73 year unbroken record of purchasing power from the Agency. It should be noted all such reporting is comprised of TVA-collected power readings, TVA-required power statistical reports or audited financial information supplied by MLEC. All MLEC financial reports are audited by a private sector audit firm annually as required by the MLEC Board of Directors.
2. An audited annual report was completed for 2011 and again was offered to OIG.
3. MLEC also files significant reporting (again annually audited financials) to United States Department of Agriculture's Rural Utilities Service ("RUS"). RUS had just completed its own audit of MLEC and found absolutely minimal discrepancies.
4. All aforementioned documents were current and offered to OIG's representatives.
5. MLEC is an electric distribution utility wholly supplied by TVA; however, we are the only cooperative distributor not subject to retail rate regulation by the Agency by virtue of its current wholesale power contract (we recognize there are also three municipal systems with the same agreement).
6. MLEC's auditor was also in attendance during OIG's presentation of its findings. His comment was "this is not an audit." He further observed the presentation document was worded in the most confrontational terminology.

MLEC begrudgingly complied with OIG's repeated request for information (otherwise available within TVA) for one reason only - the MLEC Board of Directors did not want to appear to have anything to hide. OIG is doubtless a competent organization for ferreting out TVA waste and corruption. However, we maintain OIG has no standing whatsoever to audit MLEC's retail operations. As we see it the TVA relationship ends at the wholesale delivery point. MLEC's member-elected Board of Directors is wholly responsible for all retail rates and operations through its management and staff. All MLEC member-owners are furnished copies of audited financials via a monthly magazine sent to their home address and presented at each year's Annual Meeting.

Mr. David Wheeler

- 2 -

March 9, 2012

In fairness, Ms. Neusel and the other OIG representatives who came to MLEC were courteous and professional. All tried to minimize any intrusion to the daily routine of our management, accounting, engineering and IT staff but appeared surprised by our attitude. We appreciate theirs is not an easy undertaking. MLEC has no fault with the persons sent to do the work.

As mentioned earlier MLEC is the only cooperative not subject to retail rate regulation and TVA offered that contract option to MLEC about 10 years ago. We simply do not understand why now "picking nits" is constructive. After OIG left MLEC we reviewed several other audits published on OIG's website; all appear to focus on criticizing *minor* retail account classifications and stressed TVA's "opportunities" to further regulate power distributors. While such a self-serving statement is ridiculous at first blush we choose to believe there must be a higher purpose. However, it is unclear how OIG's "audit" or additional "regulatory opportunities" would benefit anyone.

In conclusion it appears OIG is intent on restructuring working relationships that have taken approximately 60-70 years to develop. From MLEC's perspective the relationship with TVA has improved significantly over the last 4-5 years and we attribute that to the people now in leadership roles. Injecting additional regulation and bureaucracy into the equation does not appear constructive.

Thank you for the opportunity to provide comments. Please call me at (931) 729-3558 if you have questions or wish to discuss.

Sincerely,

A handwritten signature in blue ink that reads "Hal Womble". The signature is written in a cursive style with a large, stylized "H" and "W".

Hal Womble  
President and CEO



March 6, 2012

David P. Wheeler, ET 3C-K

**RESPONSE TO DRAFT AUDIT REPORT 2010-13659 – DISTRIBUTOR  
REVIEW OF MERIWETHER LEWIS ELECTRIC COOPERATIVE**

This is in response to your memorandum to Kim Greene dated February 6, 2012. As a result of the recent reorganization at TVA, the response for the distributor audits is being sent from the Retail Regulatory Affairs Department, Policy & Oversight Organization.

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

1. Discontinue or obtain TVA approval for the practice of pledging electric funds to guarantee Rural Development loans to customers.
  - TVA management agrees with the recommendation. The United States Department of Agriculture (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 distributor participation in the USDA Rural Economic Development Loan and Grant Program. Target completion date is December 2012.
  
2. Discontinue or obtain TVA approval for the practice of using electric funds for economic development.
  - TVA management agrees with the recommendation. TVA management plans to recommend to the Board that it formally approve a Use of Revenues policy which approves of using electric funds for economic developments expenses under certain circumstances.

David P. Wheeler  
Page 2  
March 6, 2012

- Actions taken or planned and completion dates: TVA management plans to recommend to the Board to formally approve a use of revenues policy which approves of using electric funds for economic developments expenses under certain circumstances. Target completion date is December 2012.
3. Properly account for economic development expenditures as non-operating expenses in account 426.1 (Donations)
    - TVA management does not agree with this recommendation. An account provided for under Section 426.1 (Donations) of the Federal Energy Regulatory Commission Uniform System of Accounts should only include "payments or donations for charitable, social or community welfare purposes." TVA does not view reasonable economic development expenditures as significantly serving welfare purposes; rather, TVA views such economic development expenditures as providing a benefit to the electric system by way of promoting or retaining the use of utility services by present and prospective customers. Accordingly, TVA management views accounts provided under section 912 (demonstrating and selling expenses) as the most proper account in which to account for economic development expenditures.
    - Actions taken or planned and completion dates: TVA will discuss with Distributor classifying reasonable economic development expenditures in account 912. Target completion date is December 2012.
  4. Review commercial and residential accounts identified as misclassified and correct misclassifications as appropriate.
    - TVA management agrees that electric service should be provided in accordance with the availability provisions of the applicable rate schedule.
    - Actions taken or planned and completion dates: MLEC will review the commercial and residential accounts that are misclassified and reclassify to the appropriate rate schedule. Target completion date is February 2013.
  5. Continue to review customer accounts, and obtain and maintain properly executed effective customer contracts for all customers with demand in excess of 50 kW in accordance with MLEC policy.
    - TVA management agrees that Distributor should execute retail contracts for customers with contract demands greater than 50 kW in accordance with the written contract requirement of the rate schedule.
    - Actions taken or planned and completion dates: TVA will discuss with Distributor obtaining executed contracts for customers with demand in excess of 50 kW. Target completion date is February 2013.

David P. Wheeler  
Page 3  
March 6, 2012

6. Formally document all decisions and approvals by the MLEC Board related to resale rate components and amounts (i.e., energy usage and demand thresholds, rate increases or decreases, amounts to charge, etc.) in the future.
  - TVA management agrees that such documentation is good business practice, and as such, TVA encourages such documentation. However, the "flexibility agreement" amending TVA's wholesale power contract with Distributor in March 2004, eliminated the Power Contract provisions under which TVA previously regulated the design and level of Distributor's resale rates and the related processes. Accordingly, TVA currently has no contract mechanism by which to mandate the recommended requirements related to Distributor's resale rates except with respect to enforcing the non-discrimination requirement of the Power Contract and the TVA Act.
  - Actions taken or planned and completion dates: No further action planned.
7. Work with MLEC to determine any amounts due to TVA associated with accounts that should have been reported as GSA Part 2 and adjust invoices appropriately.
  - TVA management agrees with the recommendation and will work with the distributor to determine if funds may be owed to TVA as a result of the misclassification. TVA understands that some of the data to calculate this amount may not be readily available and so the cost-benefit of trying to estimate this data as well as the accuracy of the data obtained will also be evaluated before moving forward. If TVA is able to determine these amounts, then invoices will be adjusted appropriately.
  - Action taken or planned and completion dates: February 2013.

*Cynthia L Herron for Cynthia Herron*

Cynthia L Herron  
Director  
Retail Regulatory Affairs  
OCP 1B NST

VB:AMM

cc: Steve Byone, WT 4B-K  
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David P. Wheeler  
Page 4  
March 6, 2012

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