

TVA CONSUMER PROTECTION ACT

HEARING
BEFORE THE
COMMITTEE ON
ENVIRONMENT AND PUBLIC WORKS
UNITED STATES SENATE
ONE HUNDRED SIXTH CONGRESS
FIRST SESSION

ON

S. 1323

A BILL TO AMEND THE FEDERAL POWER ACT TO ENSURE THAT CERTAIN FEDERAL POWER CUSTOMERS ARE PROVIDED PROTECTION BY THE FEDERAL ENERGY REGULATORY COMMISSION

OCTOBER 6, 1999

Printed for the use of the Committee on Environment and Public Works



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TVA CONSUMER PROTECTION ACT

WEDNESDAY, OCTOBER 6, 1999

U.S. SENATE,
COMMITTEE ON ENVIRONMENT AND PUBLIC WORKS,
Washington, DC.

The committee met, pursuant to notice, at 4 p.m., in room 406, Dirksen Senate Office Building, Hon. John H. Chafee (chairman of the committee) presiding.

Present: Senator Chafee.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator CHAFEE. We are now going to move to the consideration of S. 1323, introduced by Senator McConnell and Senator Bunning, called the TVA Customer Protection Act.

This was introduced on July 1, 1999 and referred to this committee. I will summarize some of the provisions.

It requires TVA to comply with the Federal Energy Regulatory Commission—FERC—regulations. It prevents TVA from recovering through power or transmission rates those costs associated with overseas activities. It prohibits TVA from competing with certain TVA distributors under long-term contract, and a series of other provisions.

We are honored to have Senator McConnell with us. Senator, before the witnesses go on—we have four witnesses here—if you would like to say a word or two and make an opening statement, that would be perfectly acceptable.

STATEMENT OF HON. MITCH MCCONNELL, U.S. SENATOR FROM THE COMMONWEALTH OF KENTUCKY

Senator MCCONNELL. Thank you very much, Mr. Chairman.

I appreciate your giving me the opportunity to be at the hearing on this bill, in spite of the fact that I am not a member of your committee. I thank you very much for having the hearing on S. 1323, which is the TVA Customer Protection Act.

I would also like to thank the witnesses for agreeing to attend this hearing and provide testimony on relatively short notice.

I want to recognize Austin Carroll, the manager of Hopkinsville Electric System, who is here, but due to the time constraints that we have this afternoon is going to have to just submit his testimony for the record.

I apologize to you, Austin, that we could not accommodate everyone.

I have introduced S. 1323, the TVA Customer Protection Act, to shine the light on the Tennessee Valley Authority. We all grew up thinking that if you had TVA power you were lucky. In fact, I was born in North Alabama—something I don't talk about a whole lot in Kentucky—the heart of TVA country. I remember from my very earliest days thinking that God had certainly blessed our area since I had been fortunate to have been born in and live in the TVA area.

Unfortunately, however, if you are the nearly 212,000 Kentucky families in 30 counties who receive power from TVA these days, it is not the case. Despite operating as a monopoly, TVA has racked up \$26 billion in debt and provides power at rates higher than the rates of regulated utilities in my State.

TVA would like Kentuckians to believe that membership has its privileges. However, over the next 5 years, TVA's Kentucky taxpayers will pay a whopping \$250 million more for their power than if they were served by Kentucky Utilities, which is federally regulated.

We have a bar chart here that represents the \$250 million that my ratepayers would be paying over and above what they would be paying if they were in a regulated utility in Kentucky.

Senator CHAFEE. Is that an annual charge?

Senator MCCONNELL. That is over 5 years, Mr. Chairman.

This chart I think is also particularly revealing. We have taken a look at the rates over the past 10 years for three regulated utilities and then for TVA inside my State. If you were in the LG&E service area over the last 10 years, your rates would have gone down 5 percent. If you were in the Kentucky Utilities area over the last 10 years, your rates would have gone down 8 percent. If you were in the Kentucky Power area, your rates would have gone down 12 percent. And if you were in TVA over the last 12 years, your rates would have gone up 7 percent.

So contrary to the perception one had as a child in North Alabama and as an adult in Kentucky, these days you are not particularly blessed to be residing in a TVA service area because your rates are higher and going higher still.

As a self-regulated monopoly, TVA has not been accountable to its captive ratepayers. As a result, TVA has accumulated a mountain of debt that has forced TVA rates upward as I just demonstrated.

TVA should be accountable to the people they serve and my bill would provide the relief to those forced to pay TVA's uncompetitive rates. The bill requires TVA to fully disclose and justify all rates, charges, and costs as "just and necessary" as required under the Federal Power Act, just as Kentucky's other regulated utilities must do.

It would also make TVA a public utility subject to the authority of the Federal Energy Regulatory Commission. This would result in TVA customers enjoying the same independent regulatory protections as customers of other large utilities. For instance, TVA customers could challenge rates rather than be forced to accept rates as set by the TVA Board.

Finally, Mr. Chairman, it would help customers hold the line on new deficit spending to ensure that TVA justifies all new construc-

tion of costly new generating facilities. This is not a cap on generation, but again a requirement that TVA demonstrate that its customers have a real need for this added capacity and that it is the most affordable solution for the valley.

Over the past several years, the General Accounting Office undertook two studies on TVA's desperate financial situation. In 1995, GAO concluded that TVA's financial condition "threatens its long-term viability and places the Federal Government at risk." In 1997, GAO found that TVA's fiscal situation poses a threat to its future competitiveness as well as a risk to the taxpayers.

Only through years of unaccountability and fiscal irresponsibility could a monopoly power with total authority to set rates ever have reached this level of debt. We need to shine the light on TVA's power rates. The legislation that we are having a hearing on today will do that by providing the ratepayer a clear picture of TVA's rates and for the first time make the Agency accountable for its charges and costs.

I do not pretend to know all the answers as to why TVA is an inefficient and costly power provider. However, it is painfully clear that at least in Kentucky TVA's customers are getting a raw deal from this new deal program. I hope this legislation will give customers the tools they need to get a better deal from TVA.

Thank you very much, Mr. Chairman.

[The statement of Senator McConnell follows:]

STATEMENT OF HON. MITCH MCCONNELL, U.S. SENATOR FROM THE COMMONWEALTH OF KENTUCKY

Mr. Chairman, I want to thank you and the rest of the Committee for accommodating me by holding a hearing on S. 1323, the TVA Customer Protection Act. I would also like to thank the witnesses for agreeing to attend this hearing and provide testimony on such short notice.

I would like to recognize Austin Carroll, the Manager of the Hopkinsville Electric System, who due to time constraints of the Committee will only be allowed to submit his testimony for the record. Austin, I look forward to reviewing your testimony and appreciate your efforts.

I have introduced S. 1323, the TVA Customer Protection Act to shine the light on the Tennessee Valley Authority. We all grew up thinking if you had TVA power, you were lucky. Unfortunately, the nearly 212,000 Kentucky families in 30 counties who receive power from TVA are finding out that's not the case. Despite operating as a monopoly, TVA has racked up \$26 billion in debt and provides power at rates higher than that of regulated utilities in Kentucky.

TVA would like Kentuckians to believe that membership has its privileges. However, over the next 5 years, TVA's Kentucky ratepayers will pay a whopping \$250 million more for their power than if they were served by Kentucky Utilities, which is federally regulated.

As you can see from the bar chart, Kentuckians captured inside the TVA fence are paying electricity rates which are higher than customers of Kentucky's regulated utilities. In 1997, TVA raised rates by 7 percent, which sharply contrasts with power rates of regulated utilities which have decreased by an average of 8 percent.

In short TVA's rates are high and going higher, and its competitors are low and aging lower.

As a self-regulated monopoly, TVA has not been accountable to its captive ratepayers. As a result, TVA has accumulated a mountain of debt that has forced TVA rates upward. TVA should be accountable to the people they serve, and my bill will provide the relief to those forced to pay TVA's uncompetitive rates.

The bill requires TVA to fully disclose and justify all rates, charges and costs as "just and necessary," as required under the Federal Power Act—just as Kentucky's other regulated utilities must do.

It would also make TVA a "public utility" subject to the authority of the Federal Energy Regulatory Commission. This would result in TVA customers enjoying the same independent regulatory protections as customers of other large utilities. For

instance, TVA customers could challenge rates, rather than be forced to accept rates set by the TVA board.

Finally, it would help customers hold the line on new deficit spending to ensure that TVA justifies all new construction of costly new generating facilities. This is not a cap on generation, but again a requirement that TVA demonstrate that its customers have a real need for this added capacity and that it is the most affordable solution for the valley.

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In 1997, GAO found that TVA's fiscal situation poses a threat to its future competitiveness as well as a risk to taxpayers.

Only through years of unaccountability and fiscal irresponsibility could a monopoly power, with total authority to set rates, ever have reached this level of debt.

We need to shine the light on TVA's power rates. My legislation will do that by providing the ratepayer with a clear picture of TVA's rates and for the first time make the agency accountable for its charges and costs.

I don't pretend to know all the answers as to why TVA is an inefficient and costly power provider. However, it's painfully clear that in Kentucky, TVA's customers are getting a raw deal from this New Deal program. I hope that this legislation will give customers the tools they need to get a better deal from TVA.

TVA CUSTOMER PROTECTION ACT OF 1999
(Section By Section Discussion)

Section 1.--Short Title.

The short title of the Act is the "TVA Customer Protection Act of 1999."

Sections 2.-- Customer Protections.

Section 2 amends the Federal Power Act ("FPA") to make TVA a "public utility" subject to the power sales and transmission service regulatory authority of the Federal Energy Regulatory Commission ("FERC"). As a result of this amendment to the FPA, the customers of TVA will enjoy the same independent regulatory protections as customers of other large utilities.

Section 3.-- Exemption From FERC Authority Over Disposition of Property.

Normally, public utilities subject to FERC's jurisdiction must obtain preapproval before they may sell or acquire facilities. Section 3 provides TVA an exemption from this requirement. The exemption is designed to enable TVA to dispose of its FERC- jurisdictional facilities without preapproval by FERC, but only if it applies the proceeds of the sale to reduce its burdensome debt.

Section 4.-- No Customer Subsidization of TVA Overseas Activities.

TVA has dedicated substantial resources in recent years to various activities overseas. These activities have no direct or legitimate relationship to the proper administration of TVA's power program. Accordingly, Section 4 makes it clear that TVA shall not be permitted to recover, through its power or transmission rates, any charge that reflects costs associated with overseas public or governmental relations initiatives. TVA also is required to prepare and file annual reports on its international activities and to make certain certifications with regard to the same.

Section 5.-- Protection for TVA Distributors and Customers.

This section contains three essential parts that protect distributors and their customers.

A. **Distributors** -- TVA's distributors are locked-in to long-term, full-requirements contracts with TVA. In the future, these distributors may secure the right to obtain wholesale power from a source other than TVA. To protect distributors that stay with TVA for half of their power needs, TVA will be prohibited from unfairly competing with that distributor.

. **B. New Generation** -- TVA will be required to meet need-based criteria before adding new generation capacity. Such safeguards are necessary to protect ratepayers from paying for unjustified and unnecessary expansions. It will protect Valley ratepayers from subsidizing off-system sales by requiring that all new generation be used in the Valley.

C. Stranded Costs -- Requires FERC to undertake an investigation to determine those costs that were prudently incurred by TVA and are eligible for recovery as a stranded costs. This will ensure that TVA customers have a clear understanding of the total universe of TVA's stranded costs or the methodology for recovery, which is currently absent.

Section 6.-- Full Disclosure By TVA.

TVA, under current law, does not make available to the public many documents and contracts that relate to its power business. Section 6 makes clear that TVA will have to file and disclose the same documents and other information that other public utilities are required to file under the Federal Power Act.

Section 7.-- Antitrust Laws.

The antitrust laws do not currently apply to TVA. This is because of TVA's status as a federal instrumentality and its historical purpose as predominately a flood control, waterway navigation and economic development agency. Over time, TVA's power program has become a commercial business just like any other public utility. Section 7, therefore, makes TVA's power business subject to the same antitrust laws and remedies as other public utilities.

Section 8.--Savings Provision

This section makes explicitly clear that nothing in the bill subjects any TVA distributor to regulation by FERC and states clearly that the bill would not affect any current law applying to a TVA distributor.

Section 9.-- Prohibition on Nonelectric Competition.

TVA's power program has begun to branch out and to provide services beyond mere power supply and transmission services. TVA's power business has diversified now to include equipment leasing and various energy-related services. Section 9 places a limit on TVA's authority to diversify into various other industries where private enterprise already exists and is capable of meeting demand. Such a limit is intended to protect private enterprises--especially small business--from competition by the government.

Section 10. -- Authorization of Appropriation.

To ensure that the Federal Energy Regulatory Commission has the necessary resources to fulfill the requirements of this legislation.

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Does Membership Have Its Privileges?

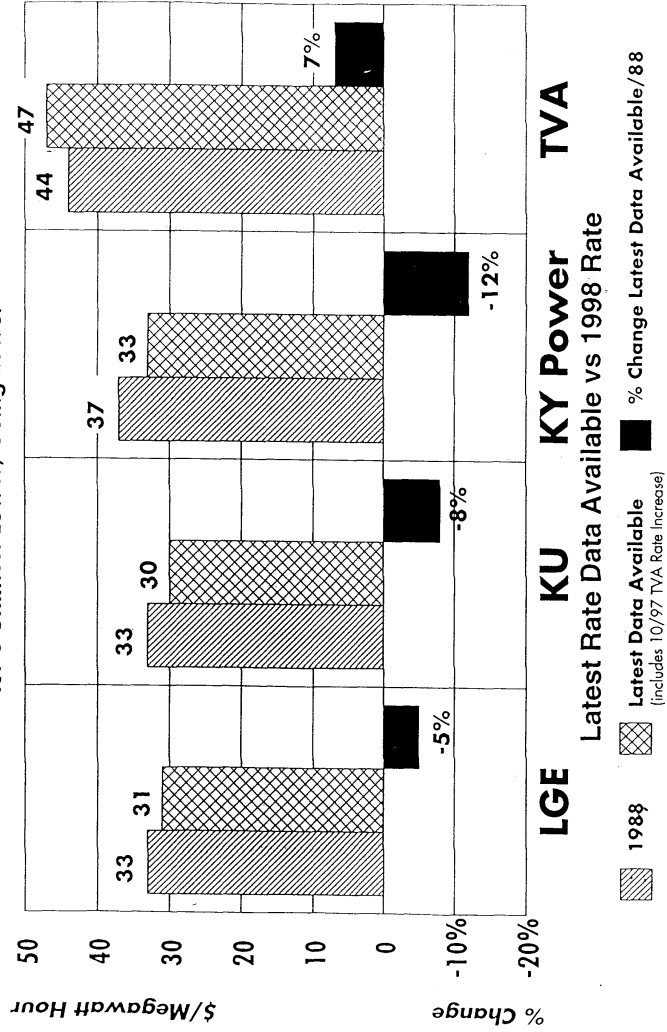


**TVA Membership Fee
1999-2003
\$249.5 million***

* Based on five year rate disparity between FERC regulated Kentucky Utilities and unregulated TVA. KU-FERC filed rates; TVA-TVA 10 year plan

Wholesale Electric Rates in Kentucky

TVA Rates: Higher, Going Higher
 KY's Utilities: Lower, Going Lower



Source: Ky's Utilities; FERC Form 1; TVA: Wholesale Power Rate Schedule WS

JOHN H. CHAFEE, RHODE ISLAND, CHAIRMAN

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United States Senate
COMMITTEE ON ENVIRONMENT AND PUBLIC WORKS
WASHINGTON, DC 20510-6175

October 6, 1998

The Honorable Trent Lott
Majority Leader
S-230 The Capitol
Washington, D.C. 20510

Dear Mr. Leader:


We write to express our opposition to a proposal concerning the Tennessee Valley Authority (TVA) that is being considered for inclusion in the omnibus appropriations or other legislation.

The proposal in question would allow the utility to refinance its debt with the Federal Financing Bank without paying the contractually required prepayment penalties. This step could result in estimated lost premium payments of \$1 billion.

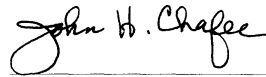
Clearly, this provision would have enormous policy and budgetary implications not only for TVA, but for the taxpayer. As members of the committee with jurisdiction over TVA, we strongly believe this proposal should not be included in omnibus legislation but instead referred according to normal legislative procedures for careful scrutiny.

We appreciate your consideration of our views on this important matter.

Sincerely,



Max Baucus, Ranking Member
Committee on Environment and
Public Works



John H. Chafee, Chairman
Committee on Environment and
Public Works



Bob Graham, Ranking Member
Subcommittee on Clean Air, Wetlands,
Private Property, and Nuclear Safety



James M. Inhofe, Chairman
Subcommittee on Clean Air, Wetlands,
Private Property, and Nuclear Safety

The Honorable Trent Lott
October 6, 1998
Page Two

Bob Smith

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R. D. Moynihan

Craig Thomas

PADUCAH POWER SYSTEM



1500 BROADWAY P.O. BOX 180 PADUCAH, KY 40002-0180 PHONE (270) 575-4000 FAX(270) 575-4027

July 1, 1999

Senator Mitch McConnell
361 A Russell Building
1st & C Streets, NE
Washington, DC 20510

Dear Senator McConnell:

Having reviewed the "TVA Customer Protection Act of 1999," the Board and management of Paducah Power System are supportive of the bill.

Specifically, the protection from TVA competing with the distributors for retail customers as long as at least half of the distributors wholesale power requirements are purchased from TVA is very important.

The provision for identifying and establishing the methodology and value of stranded cost is extremely important. This information will assist future planning for distributors.

Additionally, the protection of Valley ratepayers from subsidizing off system sales provides distributors within the Valley to continue to provide energy at the lowest practical cost.

Thank you for your efforts and continuing interest in the people of Western Kentucky and all the Tennessee Valley.

Feel free to call if I can be of any assistance

Respectfully,

Don Fuller, PE
General Manager

DF:nw

Senator CHAFEE. Thank you, Senator.
There is a statement here from Senators Inhofe and Bunning and I will ask that they go into the record and be accepted as part of the record.
[The prepared statements of Senators Inhofe and Bunning follows:]

STATEMENT OF HON. JAMES M. INHOFE, U.S. SENATOR FROM THE STATE OF OKLAHOMA

I am pleased we are having this hearing on the Tennessee Valley Authority. TVA is a subject within my Subcommittee, and unfortunately due to so many pressing issues we have been unable to hold an oversight hearing before now.

Like many in Congress, I believe the monopoly of the TVA is a dinosaur in today's electric power business. Due to actions by State legislatures and Congress, the electric marketplace is changing at a rapid pace. While we may not have reached consensus on how best to proceed, action by the states or Congress is going to lead to-

ward deregulation of the electric industry. With all other aspects of the electric industry changing, I believe the time has come for TVA to change as well.

In light of the deregulation debate, I believe TVA's government protected monopoly has outlived its usefulness. For too long, problems at TVA have been ignored or swept under the carpet—although I am not sure how it is possible to ignore a \$28 billion debt. The debt refinancing plan which was attached to last year's Omnibus Appropriations Act was wrong and should not have occurred. In bypassing the committee of jurisdiction, it is estimated that it cost the taxpayers over \$1 billion. These actions have simply become too large for Congress or the American people to remain silent. Created during the New Deal when only 15 percent of rural America enjoyed electricity, it is time for the reign of this bloated bureaucracy to come to an end. I believe the legislation before the committee today is a step in the right direction and long overdue.

STATEMENT BY HON. JIM BUNNING, U.S. SENATOR FROM THE COMMONWEALTH OF KENTUCKY

Mr. Chairman, Thank you for providing me the opportunity to submit my testimony for the record on S. 1323, the Tennessee Valley Authority (TVA) Customer Protection Act. As a cosponsor of the bill, I wanted to share with you and our colleagues some of my thoughts on why and how this bill will improve the administration of the TVA and benefit consumers.

For the past fifty years, TVA has been both a competitor and regulator within the transmission and power-generation industry. Unfortunately, at times these two roles have clashed, and as a result the customers of TVA have had to deal with higher rates than the people living outside of TVA's "fence line." In the past, the TVA Board of Directors has tried to justify this to the people of the Valley by blaming their higher rates on the mammoth \$26 billion in debt that they have acquired over years of operation. However, they simply miss the point that it is the Board's mismanagement and, in fact, the lack of oversight by the Federal Government that led to the acquisition of this debt. The TVA Crammer Protection Act will change this and bring some accountability to the TVA, and provide a layer of oversight by the Federal Energy Regulatory Commission to prevent further bad business decision making.

Currently, the TVA is not required to make available to the public any of its documents and contracts that relate to its power business. However, under S. 1323, TVA will have to file and disclose the same documents and information that other public utilities are required to file under the Federal Power Act. The Tennessee Valley Authority has stated that they want to be "America's power company." If this is the case, the TVA should operate under the same regulations as the rest of America's power utilities.

In addition, our antitrust laws do not currently apply to TVA. This is wrong, and must be corrected. It is time that TVA be held to the same standards as the rest of our utilities. This bill will accomplish this goal, and provide the customers of the TVA some course of legal action in the future.

I want to make it clear that this is a pro-TVA bill. It is simply an attempt to bring some reform to the agency, and prepare it for the future. It is clear that TVA will have to change its ways if it is going to compete in any future deregulated electricity market. This bill is a good first step in preparing them for that new market, and preparing TVA's customers for the future.

For too long, the consumers of TVA's power have had to pay higher electricity rates than people living outside of the fence line. In the State of Kentucky, it is estimated that over the next five years that the customers of TVA will have to pay almost \$250 million more for their electricity than if they had received it from a FERC-regulated utility. That is a bitter pill for my constituents to have to swallow, and hopefully this bill will provide them some rate relief.

Again, Mr. Chairman, thank you for allowing me to submit my testimony. I look forward to working with you on preparing TVA for the next century.

Senator CHAFEE. Now our first witness is Mr. Don Fuller, general manager, Paducah Power System.

We will put each of your full statements in the record. These lights will go on allowing each witness 5 minutes. If you could stay within the 5 minutes, that would be helpful. The green light will go on, then the red at the conclusion of the period.

Thank you.

**STATEMENT OF DON FULLER, GENERAL MANAGER, PADUCAH
POWER SYSTEM**

Mr. FULLER. Thank you, Mr. Chairman.

My name is Don Fuller and I am the general manager of Paducah Power System. I appreciate the opportunity to come before you today.

I represent the position that the Board at Paducah Power and the city of Paducah has on several of these issues relating to restructuring of the electric industry and part of the bill that Senator McConnell has introduced. The main points we want to present is to remove the barriers to wholesale electric competition in the Tennessee Valley, subject TVA to the jurisdiction of the Federal Energy Regulatory Commission, including the FERC jurisdiction over TVA's transmission system, wholesale power sales and stranded costs, terminate TVA regulation of the distributors and revert that to local control, and apply the Federal anti-trust laws to the same extent that such laws apply to other Government entities.

Part of that is looking into the future and not so much as the very present in such things as anti-cherry picking and the well-known TVA fence. We also think that TVA should be subject to all of the transmission tariffs that affect other public utilities or other utilities in the industry.

Wholesale power rates should be subject to review by FERC, as well as the stranded costs if an entity decides to get out. We think that FERC order 888 covers that measure of determining what those stranded costs are.

The retail sales of TVA into our jurisdiction should be terminated at some point where TVA would become just a wholesaler and not a retailer, thereby restricting any competition they would have against the small retailers.

As far as selling outside the Tennessee Valley, S. 1323 does not address that issue. At some point in the restructuring of the industry I do not believe that TVA should be limited to selling outside. Surely as the fence comes down, it should come down in both directions.

Thank you, Mr. Chairman.

Senator CHAFEE. Mr. Hewett, president, Kentucky Utilities Company.

**STATEMENT OF ROBERT M. HEWETT, PRESIDENT KENTUCKY
UTILITIES COMPANY**

Mr. HEWETT. Thank you, Mr. Chairman and Senator McConnell.

My name is Robert M. Hewett and I am president of Kentucky Utilities Company, a subsidiary of LG&E Energy Corporation, a diversified energy services company with businesses in power generation and project development, retail gas and electric utility services, and asset-based energy marketing.

Kentucky Utilities serves 77 counties in Kentucky and 5 in Virginia. In addition, LG&E Energy also owns Louisville Gas and Electric Company, which services 16 counties in Kentucky. My company is also a member of TVA Watch, a coalition of investor-owned utilities operating in areas adjacent to the Tennessee Valley Authority, TVA. We appreciate your invitation to share with this

committee the views of TVA Watch about the role the Tennessee Valley in the changing electric power industry.

I would like to emphasize several points that are set forth in greater detail in my written statement.

First, TVA has many powerful tools, such as exemptions from Federal and State regulation, as well as tax and antitrust laws that are not available to other utilities. These powerful tools led the Congress in 1959 to the fence that contains TVA within its current region. During the past 4 years, however, TVA has been carrying out a strategy to undermine the fence. As a result, my company and others in TVA Watch have had to sue TVA on more than one occasion to force TVA to comply with the law. Although we have prevailed in each instance, we believe that it is necessary to remain vigilant against other potential abuses of the 1959 law by TVA.

Second, our electric power industry already is becoming more competitive and will continue to do so whether or not Congress passes a restructuring bill. The only way this competition can work for the benefit of consumers is if the success of any market participant is based on the quality of its service, the health of its balance sheet, and whether it competes under the same rules as everyone else.

If its financial health is not up to par, then its management had better fix it. Unfortunately, TVA's financial health is not up to par. Even more unfortunate is the fact that TVA's management appears intent on convincing the public that TVA has no financial problems and that it is ready for competition under rules less stringent than those that govern other utilities. We submit that TVA has it backward. TVA should fix its financial problems first and then be prepared to compete under the same rules as everyone else.

Third, Congress also should closely examine TVA's claims that is a low-cost utility that pays its fair share of taxes. Neither claim holds up. In Kentucky, TVA is the most expensive provider of wholesale power. Its rate to wholesale distributors is \$47 per megawatt hour or 4.7 cents per kilowatt hour. In contrast, the wholesale full requirements rate my company charges to our municipal customers is \$29.4 per megawatt hour or 2.94 cents per kilowatt hour. In fact, by the year 2003 our wholesale full requirements rate will be 2.91 cents per kilowatt hour while TVA projects that its 4.7 cents per kilowatt hour rate will remain the same.

In the case of taxes, the best way to consider this issue is on an apples-to-apples basis—total tax obligation as a percentage of total revenue. In 1998, TVA total payment in lieu of tax obligation was 3.9 percent of total revenue. Kentucky Utilities total tax payment accounted for 8.1 percent of total revenue.

Fourth, we need to consider what TVA believes to be fair competition. TVA insists that it must retain control over its prices and sales practices rather than have its prices and practices subject to review by the Federal Energy Regulatory Commission. TVA also insists that while it is willing to be subject to anti-trust laws, it should not be subject to fines or attorneys fees because it could not afford to pay them. We find both positions to be without substance. Put another way, my company pays its full share of taxes, follows all the rules, protects the environment, makes money for our shareholders, and still charges lower rates than TVA.

We applaud Senators McConnell and Bunning for introducing S. 1323, which would go a long way toward ensuring that any competition between TVA and other utilities will be fair. We are very pleased that the companion legislation has been introduced in the House by Congressman Richard Baker.

I thank the committee for the opportunity to present our views and would be please to respond to any questions.

Senator CHAFEE. Thank you very much, Mr. Hewett.

Mr. Munson, executive director, Northeast-Midwest Coalition.

**STATEMENT OF RICHARD MUNSON, EXECUTIVE DIRECTOR,
NORTHEAST-MIDWEST COALITION**

Mr. MUNSON. Thank you, Mr. Chairman and Senator McConnell.

Noting that I have a short time, I will attempt to be quite blunt. Following up on Senator Baucus' comments, I would like to suggest that TVA is an embarrassing bureaucracy burdened with debt and mismanagement. You are going to hear in a second from Mr. Medford that TVA is financially sound and a well-run company. How can a well-run company accumulate a \$28 billion debt? Such a feat, done at a time when they set their own rates, and they enjoy monopolistic control over their service territory—such a feat has to rank among this Nation's most egregious examples of business mismanagement.

The TVA Board, finally in 1997, could not avoid this disaster any longer and came up with a 10-year plan to try to cut that debt in half by the year 2007. Great idea. Unfortunately, the General Accounting Office finds that the plan is filled with what it refers to as "unreasonable assumptions."

TVA also, unfortunately, has ignored GAO's suggestions to update the plan. And most troubling, Agency officials—wanting now to build more power plants and expand their empire—are saying that they never really meant to have debt reduction as a goal in the first place. They have had their high-priced lobbyists oppose provisions within the VA/HUD bill that would scale back TVA's \$30 billion debt ceiling.

Unfortunately, according to GAO, most of the very small progress made in the past 2 years on debt reduction has come because of the subsidies, not because of increased efficiency at TVA. TVA may be lost in its quest for bureaucratic growth, but I would suggest that the American taxpayer and this Congress—which ultimately has oversight of TVA—needs to ensure that debt reduction is the highest priority for this debt-laden agency. The American taxpayers should not be saddled with TVA's debt.

On the mismanagement side, is it a well-run company that in recent weeks has been the brunt of embarrassing accounts of mismanagement? Consider the story about the inspector general we heard about before. About a year ago the inspector general issued a scathing report about six-figure bonuses, secret retirement accounts, and noncompetitive consulting contracts for cronies and senior executives. Did TVA respond to those charges? How they responded was to launch a retaliatory investigation against the IG and issue a string of ugly charges about the IG to the press.

Fortunately, because of Senator Thompson's good oversight, the General Accounting Office investigated those charges and just 2

weeks ago issued a report that said that the chairman's investigation of the IG "could be viewed as an attempt to undermine the independence" of the TVA watch dog. TVA went further to say that management's charges against the IG were nothing more than "unsubstantiated allegations."

Consider also the embarrassing millions of dollars TVA is spending on lobbyists and public relations consultants. There was a recent story that showed that TVA was paying up to \$435 an hour for consultants to research TVA critics and to book the chairman giving speeches outside of the Tennessee Valley. Consider the \$1.6 million that TVA on Friday admitted it overcharged its industrial customers last year because of some supposed unintended computer error. Industrial customers are suggesting the overcharge is closer to \$100 million.

Mr. Chairman, TVA is a national problem because it is a Federal agency that burdens taxpayers with its debt. Yet Tennessee Valley consumers—I should think—should be outraged by this giant and arrogant monopoly.

Why should they pay \$435 an hour to book the chairman's speech at Harvard University? Why should they allow TVA management to stifle independent analysis? But most importantly, why should they remain subject to TVA's monopoly control while the rest of the country begins to enjoy the lower costs and better service that result from competition?

Senator McConnell has noted that his Kentucky constituents outside the TVA service territory enjoy lower rates than those within. Other competitors in a restructured market are going to offer better deals. So why should Tennessee Valley customers be left behind? Simply because of some Government bureaucracy and monopoly?

As this committee considers how to restructure TVA in a competitive market, I encourage you to raise the fundamental question about whether the Federal Government, in the 21st century, has any business being in the electricity business. We wouldn't fathom having the Air Force compete against Delta Airlines, yet TVA will argue that Washington needs to continue to own and control the Nation's largest utility.

Why? Is there some failure in the electricity market that would require the Federal Government's intervention? There might have been 70 years ago when only 15 percent of rural Americans enjoyed electricity. But today, there are hundreds of private sector companies and entrepreneurs out there who are struggling for the chance to sell electricity in an open and competitive market.

While Congress will discuss these fundamental questions during the restructuring debate, I hope this panel more immediately advances needed reforms. Senator McConnell has proposed numerous, very logical changes affecting FERC oversight and anti-trust laws that would help ensure TVA plays by the same rules as other power generators.

In order to protect U.S. taxpayers, I would hope that you add to that bill a measure to force TVA to slash its massive debt by ratcheting down its debt ceiling.

TVA is a troubled bureaucracy, Mr. Chairman. It needs serious reform and restructuring.

Thank you.

Senator CHAFEE. Thank you, Mr. Munson.

Mr. Mark Medford, executive vice president, customer service and marketing, Tennessee Valley Authority.

STATEMENT OF MARK MEDFORD, EXECUTIVE VICE PRESIDENT, CUSTOMER SERVICE AND MARKETING, TENNESSEE VALLEY AUTHORITY

Mr. MEDFORD. Mr. Chairman, I want to thank you for this opportunity to update the committee on a variety of issues relating to TVA's ongoing activities and electric industry restructuring, including S. 1323.

My name is Mark Medford and I serve as TVA's executive vice president for customer service and marketing. My responsibilities include working with the 159 distributors of TVA power and 63 directly served customers within the Tennessee Valley who would be most affected by restructuring legislation.

Mr. Chairman, before I begin my testimony, I would like to ask permission to submit testimony from Austin Carroll, representing the TVA Kentucky Managers' Association, and Miles Manell, representing the Association of Tennessee Valley Governments, who were not able to appear before the panel.

Senator CHAFEE. Without objection, those prepared statements will appear in the record.

Mr. MEDFORD. Thank you.

I applaud this committee's interest in the issues surrounding TVA's role in the evolving electric power industry. As you well know, other committees in both the House and Senate are considering issues related to industry restructuring at both the State and Federal level. TVA has been actively involved in these efforts. At the risk of stating the obvious, I can tell you that sorting out these issues in the context of Federal legislation is not an easy task.

TVA has begun the difficult process of preparing itself for the new competitive environment. We have made painful staff reductions, cut costs, increased productivity, and decreased debt.

In 1997, TVA unveiled a comprehensive program to guide our agency for the next 10 years. The overriding goal of this 10-year business plan is to ensure TVA's electricity will remain competitive.

In the fall of 1997, the Department of Energy created the Tennessee Valley Electric System Advisory Committee. The purpose of this body was to build consensus and make recommendations for legislation that would shape the future of TVA. In addition to TVA, the participants included the Tennessee Valley Public Power Association, representing the distributors, large industrial customers directly served by TVA, industrial customers served by the distributors, the Southern States Energy Board, local environmental interests, rural consumers, the League of Women Voters, the International Brotherhood of Electrical Workers, and the Teamsters. As national energy stakeholders, ENRON, TVA Watch, and the Electric Clearinghouse also participated.

Relying on the final report of the advisory committee, the Administration crafted a TVA title for inclusion in its comprehensive Electricity Competition Act. TVA supports this proposal. Also, the

TVA congressional delegation strongly urged TVA to work directly with TVPPA to develop a regional solution for inclusion in a legislative proposal.

I was pleasantly surprised at the amount of agreement between TVA and its customers. We have since jointly submitted recommendations to our delegation.

The Administration and the TVPPA/TVA proposals are very similar. The most important characteristic is that they both represent regional consensus and regional compromise. Significantly, they were developed with the input of TVA's customers. These proposals, above all, affirm TVA's continued role within the valley to manage the river system and provide electricity for valley customers.

However, we also note the new responsibilities and limitations that TVA will have in an emerging marketplace. For instance: TVA would be required to make its transmission system available to competitors for customers in the Tennessee Valley Region; TVA would be subject to anti-trust prohibitions; TVA transmission rates would be subject to FERC jurisdiction; TVA would be required—unlike any other utility in the country—to renegotiate all existing full requirements contracts with distributors within a year of enactment.

Perhaps the most critical element of the agreement with our distributors is that changes should only come in the context of comprehensive legislation. It simply does not make sense to enact changes to TVA that may not conform to broader congressional policies about the future of the industry.

There is also agreement that TVA should have the ability to build new generation to serve the needs of the valley. Mr. Chairman, this is where we have big concerns with S. 1323. This legislation would place significant burdens on our ability to add new generation. I believe these burdens are insurmountable. The demand for electricity in our region is growing at about 4 percent annually. Like most of the country, we are pushing the bounds of our current generation capacity. We have been fortunate that TVA has never had a capacity-related outage, period.

The limitations on new generation included in S. 1323 put electric reliability at risk for our 159 customers and in turn the 8 million people they serve across the valley.

As the electric power industry changes, its greatest strength is its diversity. Ranging from rural electric cooperatives to municipal systems to the largest private companies, this variety should be embraced and nurtured as we move forward.

Mr. Chairman, we have made important progress in developing a regional consensus. I hope that we can continue to work together to build on this consensus and find a solution that truly fosters markets and helps customers in the Tennessee Valley.

Thank you for the opportunity to testify before this important hearing. I look forward to answering your questions.

Senator CHAFEE. Thank you very much.

Senator McConnell, would you like to ask some questions now?

Senator McCONNELL. Thank you, Mr. Chairman.

Mr. Medford, you said in your prepared statement that the principal purpose of TVA was to protect customers from prices that might exceed those charged in a competitive market.

As I discussed in my opening statement, there are three utilities in Kentucky, which are all federally regulated, that serve people in my State at rates below TVA.

Why is that?

Mr. MEDFORD. I will make two observations, Senator McConnell.

First, Kentucky is blessed with having some of the lowest electricity rates in the country. I will also observe, while much has been discussed about wholesale rates within Kentucky, the average retail price of electricity for TVA and its distributors—in the TVA-served portion of Kentucky—are among the lowest rates in the State. Only one other major provider has an average retail rate lower than that in the TVA part of Kentucky.

Senator MCCONNELL. Do you want to respond to that?

Mr. HEWETT. Yes, sir.

As far as the retail rates, Kentucky Utilities for sure would have retail rates that are lower than TVA's rates. The average rate for Kentucky Utilities retail residential customers would be about 4.5 cents per kilowatt hour and for an industrial customer it would be about 3.2 cents per kilowatt hour. So we would have lower rates than TVA would.

Senator MCCONNELL. Then you are disputing what Mr. Medford just said?

Mr. HEWETT. That's right.

Mr. MEDFORD. I will tell you how we arrived at this information.

Senator MCCONNELL. You guys must be using a different calculator. Is that it?

Mr. MEDFORD. No, I will tell you how we arrived at this information.

We took the revenues for each of the major providers—I am talking about the 10 largest providers in the State—we took the revenues collected at the retail level and divided them by the kilowatt hours sold. It is a pretty simple process.

Mr. HEWETT. Senator, TVA has a comparison of rates as far as retail customers. It is a survey that my company has participated in. That survey itself would document what I said.

Senator MCCONNELL. So you're saying, Mr. Medford, that contrary to my chart and my belief, that in fact the retail rates of TVA inside Kentucky are lower than the investor-owned utilities?

Mr. MEDFORD. The first thing I will observe, Senator McConnell, is that your charts are based on wholesale rates. My response was based on retail rates.

And I don't want to miss the first point that I made—and I will stress it again. Kentucky, as a State, enjoys some of the lowest costs in the country. TVA's rates are competitive.

Senator MCCONNELL. I understand that. We are sitting on a lot of coal.

The only issue I am probing here is the one we are debating, which is who has the lower rates. And you are saying that the retail rates of TVA are lower inside Kentucky—

Mr. MEDFORD. Than all but one of the other nine or ten major providers.

Senator MCCONNELL. Which is the one?

Mr. MEDFORD. Big Rivers.

Senator MCCONNELL. And you dispute that, Mr. Hewett?

Mr. HEWETT. Yes, sir, most definitely.

Senator MCCONNELL. I do not think we can resolve this this afternoon, but somebody is obviously wrong here and we will need to look at that further—unless somebody has some great idea about how to resolve this dispute.

Mr. HEWETT. Senator, we could obviously get the tariffs of both companies and build them out. That would be very easy to do.

Senator MCCONNELL. If it is all right with Chairman Chafee, I would like to leave the record open for some further submissions on this point from the witnesses. I don't think there is anyway to resolve this this afternoon, but I would be interested in hearing further from all of you about that issue.

Senator CHAFEE. That's fine. Do they know exactly know what they are responding to?

Senator MCCONNELL. Well, Mr. Medford is saying that my chart may have been right with regard to wholesale rates but are not right with regard to retail.

Is that correct?

Mr. MEDFORD. That is correct.

Senator MCCONNELL. And Mr. Hewett is disagreeing with him.

It seems to me there is no way to resolve it this afternoon. I would like to have further submissions if that is OK with you.

Mr. Medford, you noted that it is unacceptable to have FERC oversight over TVA with regard to wholesale electricity rates, yet you are willing to submit to FERC oversight on transmission and stranded costs.

Why is it OK for one and not OK not OK for the other?

Mr. MEDFORD. The primary reason is that the TVA Board is charged with providing electricity in the valley at the lowest possible cost. That is a directive, by the way, which is not entirely consistent with the directive given by FERC.

I see no purpose for one set of Presidential appointees overseeing another set of Presidential appointees in the determination of wholesale electricity prices. When you get into the area of transmission, the transmission network is not purely a regional issue. The transmission network—basically you are talking about three major components of transmission for the country, those being the western part, the eastern part, and Texas.

With regard to stranded costs, stranded cost—FERC is the expert on stranded cost. FERC laid out the methodology for determining stranded costs and therefore I think it is entirely appropriate that they adjudicate stranded costs.

Senator MCCONNELL. Would any of the three other witnesses like to respond to that?

Mr. HEWETT. Senator, what the FERC is attempting to do through open access on the transmission tariffs and deregulation of transmission tariffs is to make sure that every customer has the opportunity to compete in an unregulated fashion when competition does prevail. So what FERC is trying to accomplish is to make sure that comparisons are achieved in an equal fashion to make

sure that we do establish rates and that it is done in a fashion that is the same for everyone so that there is that equal access.

My response would be that it is important to make sure that comparisons are done on the same basis. I think deregulation of transmission tariffs by the FERC is a way to accomplish that.

Senator MCCONNELL. Any comments from Mr. Fuller or Mr. Munson?

Mr. FULLER. I would agree with that.

Mr. MUNSON. I would just followup on Senator Thompson's comment about the unaccountability of TVA. The decisions of the Board are not reviewed by State regulators, FERC, other Federal agencies. Congress has not provided a lot of oversight recently. Because they have monopoly control over their service territory, they are not even accountable to market forces. I think FERC oversight makes perfectly logical sense to bring a little bit of accountability to this unaccountable agency.

Senator MCCONNELL. Mr. Medford, at some point, I think we would all agree that fence is likely to come down and TVA will be allowed to compete in an open market. Under the legislation you support, what FERC regulatory requirements would TVA be required to fulfill outside the fence that it is not required to meet inside the valley?

Mr. MEDFORD. We are aware that some legislative proposals have included provision for FERC regulation of TVA sales outside the fence and TVA does not oppose that.

Senator MCCONNELL. Why doesn't TVA think that the stranded cost formula that FERC applies to public utilities should apply to its own stranded costs?

Mr. MEDFORD. It is not quite as simple as that, Senator McConnell.

Let me talk about the scope of application of stranded costs in TVA as opposed to other utilities.

I served for 14 years with a private utility. Our sales structure was about 94 percent at retail and 6 percent at wholesale. TVA's sales structure is quite different from that. Approximately 85 percent of our sales are at wholesale and 15 percent are at retail.

So when you talk about stranded costs of losing wholesale customers, the issue is much more substantial for TVA than it is for the typical private utility. We are not saying that the standard FERC formula will be found to be inappropriate by FERC or TVA. It may be. We want to allow the FERC the latitude—after hearing from TVA, TVA's customers, and others—to use some approach other than the standard methodology they have laid out for others.

Senator MCCONNELL. In March, Standard and Poor's rating service put out a notice regarding problems that might be created for TVA as a result of competition. S&P noted that the Administration's legislative reforms could have implications for TVA's rating and that TVA's future operation and financial profile could be impaired.

That doesn't exactly sound like a ringing endorsement from Wall Street.

What is your reaction to that?

Mr. MEDFORD. Given that we have endorsed the Administration's title and the TVA/TVPPA proposal—which is very similar to the

Administration's title—obviously we disagree with them. We think both of those documents represent a fair treatment of TVA in a competitive environment and will not have any untold adverse effect on TVA's financial condition.

Senator MCCONNELL. Finally, Mr. Medford, once the fence comes down, what will TVA's mission be with regard to its current service area?

Mr. MEDFORD. We see TVA as primarily a regional provider. We certainly are almost exclusively a regional provider today. Our roots are in the Tennessee Valley. We see ourselves being primarily a regional provider as we go into the future.

I would also take note that most of the legislative proposals that have been discussed in terms of bringing down the fence, bring down the fence in a rather limited manner. True, we would be able to sell outside the fence, but with substantial restrictions, one of them being that we would not be allowed to sell at retail outside the region.

Senator MCCONNELL. Mr. Fuller, Paducah Power is uniquely located with other power suppliers right nearby.

Mr. FULLER. Yes, we are, and that perhaps represents some of the differences we have with some of the proposals from TVPPA.

Senator MCCONNELL. Let me just say in that regard—I am curious. These neighboring suppliers really offer more competitive rates than TVA, do they not?

Mr. FULLER. Some of their wholesale rates are, yes. Paducah Power System is located basically on an island surrounded by providers of non-TVA power. You have to go some 20 miles in three directions to get to the closest other TVA distributor.

Senator MCCONNELL. What opportunity do you have or do your customers have to challenge the rates imposed by the TVA Board? Do you have any opportunity for review or challenge of any of these charges TVA has incurred?

Mr. FULLER. Typically not. We are allowed to enter into conversation, but I do not think it gets real serious. We have no negotiating power to speak of.

Senator MCCONNELL. You are in the middle of a 10-year contract?

Mr. FULLER. We have signed what is called the five plus five contract, and 2 years of that have passed.

Senator MCCONNELL. What do you plan to do at the end of the contract? Or is that something you are not prepared to say yet?

Mr. FULLER. I am not prepared to say at this point. Our board, several years ago, voted to terminate what was in the full tenure contract—or to give notice to TVA. And when the opportunity came up, and with the provisions of the five plus five, they voted to not go ahead and give that notice but to go ahead and sign the five plus five contract.

Senator MCCONNELL. Memphis and Knoxville have been outspoken in their differences with TVA. How does your position compare with these two larger utilities? And are you aware of distributors who support these views but are fearful of speaking out against TVA?

Mr. FULLER. Having read the position by KUB and also Memphis, our views—which really pertain to our uniqueness and loca-

tion with respect to the rest of the Tennessee Valley—our views are pretty much the same as Knoxville and Memphis.

I know perhaps two or three others that hold the same view, but their location within the valley is not as particularly unique as Paducah's.

Senator MCCONNELL. Mr. Fuller and Mr. Hewett, TVA has said that FERC oversight would impose a cost burden which may require them to raise their rates.

Does your experience support that statement?

Mr. HEWETT. No, sir, it does not.

What the FERC would do is look at what the costs are and identifying whether or not there is investment you have made that is appropriate investment. So there is a real possibility that some investment might be found to be not supported by the customers' needs. I would think the possibility would be to the contrary.

Senator MCCONNELL. I gather TVA argues that it cannot be FERC-regulated and be able to satisfy Wall Street. How is it that LG&E Energy is able to accomplish this while maintaining some of the lowest rates in the Nation?

Mr. HEWETT. Sir, we have always felt that the ability for us to maintain some of the lowest rates is the fact that there has been very sound regulation, as exists within the FERC as well as within our home State of Kentucky. We feel that the regulation that has been provided as well as management's ability to work with our regulation has allowed us to maintain the low rate levels we have accomplished.

Senator MCCONNELL. Mr. Chairman, I have a bunch of questions I would like to have these folks answer in writing, if that is permissible.

Senator CHAFEE. We want to give them some time. Why don't we give them 2 weeks.

How complicated are the questions?

Senator MCCONNELL. We have 30 or 40—much more detailed, Mr. Chairman, than we have the time to go into today, but I do think it would help complete the record.

Senator CHAFEE. Who are they submitted to?

Senator MCCONNELL. To all four.

Senator CHAFEE. Gentlemen, that is quite a challenge for you. Can you meet that challenge in 2 weeks? You have not seen them, so you are in the dark a little bit.

Senator MCCONNELL. We will give them to you today and that will start the process.

Senator CHAFEE. Well, do what you can and get the questions back in to the committee here.

Mr. Medford, I would just like to ask you a quick question.

Your seat mate has some pretty tough statements. TVA has accumulated a whopping \$28 billion debt largely because of inaccurate predictions of future electricity demands. I must say that I was stunned to hear that you had a debt of \$28 billion.

What do you say to that?

Mr. MEDFORD. First of all, that is a slight overstatement because it is less than \$27 billion.

Senator CHAFEE. OK, we won't argue over a billion. Make it \$27 billion.

Mr. MEDFORD. First, one needs to remember that the debt market is basically the only form of capitalization TVA has. We do not have stockholders, we do not issue stock. So the debt from that perspective seems larger than it otherwise would.

I will also acknowledge—if you look at TVA as an operation, we are a very well-run, very efficient, and very low-cost operation. We have a large challenge and that is that we are somewhat over-capitalized. That indeed was and is one of the purposes of the 10-year plan, to reduce that capitalization.

I do not think of it as a whopping \$27 billion. I think that was a challenge to this management and we intend to meet it.

Senator CHAFEE. And then he goes on to say that TVA is exempt from hundreds of Federal and State laws and regulations, pays no Federal estate taxes, obtains low-cost loans because of this implied support—all that is true, isn't it?

Mr. MEDFORD. As I mentioned in my testimony—

Senator CHAFEE. I think Mr. Hewett was talking about what percentage of his revenue he pays in taxes—what was it again?

Mr. HEWETT. Mr. Chairman, 8.1 percent.

Mr. MEDFORD. According to my understanding, he also dramatically understated our in lieu of taxes. Our in lieu of taxes are about 5 percent of our revenues. If you look at TVA's and TVA's power distributors' together, our total percentage at a retail level is something in excess of 6 percent.

Having said that, I will acknowledge that public power entities enjoy some benefits relative to private power entities. Private power entities—and again, I have worked more in the private power industry than I have in the public power—enjoy many advantages which we do not enjoy.

Senator CHAFEE. You point out somewhere in here that you have reduced your employment very, very substantially—over the past 5 years, I believe—from 30,000 to 13,000. That is an extraordinary figure. Is that accurate?

Mr. MEDFORD. It is indeed.

Senator CHAFEE. Are you all finished, Senator?

Senator McCONNELL. Thank you, Mr. Chairman.

Senator CHAFEE. This is quite a burden we are asking you to comply with, but we will get you those questions right away. If you could answer them and send them in, we would appreciate it.

Thank you all very much for coming.

That concludes the hearing.

[Whereupon, at 4:55 p.m., the committee was adjourned, to reconvene at the call of the Chair.]

[Additional statements submitted for the record follow:]

[From the Lexington (KY) Herald-Leader, Wednesday, July 28, 1999]

TVA'S RIVER OF DEBT

REGULATE TVA BUT DON'T MAKE IT VULNERABLE TO TAKEOVER

While this blistering summer brings brownouts and power outages to the Northeast, the Tennessee Valley wallows in megawatts. All that generating capacity comes at a price.

Customers of the Tennessee Valley Authority in Kentucky and six nearby States are stuck paying off the federally owned utility's debt—\$26 billion.

This swamp of red ink is the product of a nuclear building binge launched 30 years ago. TVA's all-powerful, three-person board grossly miscalculated the region's needs and the difficulties of bringing nuclear plants on line. Consumers are paying for those mistakes.

U.S. Senator Mitch McConnell of Kentucky has introduced legislation providing some protection from such ill-advised decisions in the future.

McConnell's bill would subject TVA's rates to the same scrutiny as those of other electrical wholesalers. The Federal Energy Regulatory Commission would have to approve TVA's rates.

McConnell's legislation also gives the public and the 159 local utilities that are TVA's captive customers access to information about the basis of TVA's rates and the right to challenge those rates. Surprisingly, privately owned utilities are required to reveal financial information that the taxpayer-owned TVA can keep secret. McConnell would end that absurdity.

Compared with most of the country, TVA's rates are cheap. But McConnell estimates that over the next 5 years, TVA's 212,000 residential customers in Kentucky will pay \$250 million more than if they were getting their power from Kentucky Utilities Co.

You can see why McConnell is demanding stronger oversight and accountability. TVA has enjoyed government subsidies, a monopoly and complete autonomy since its creation 66 years ago. McConnell would require TVA to behave more like a privately owned, would require TVA to behave more like a privately owned, government-regulated utility. And that's fine.

But we worry that another provision in McConnell's bill could tilt the playing field against TVA in the deregulated market of the future.

McConnell would prohibit TVA from adding generating capacity beyond what's needed in the region, protecting TVA ratepayers from subsidizing off-system sales.

This makes sense as long as TVA has no competition and, as a practical matter, should have no effect in the near future because TVA isn't likely to take on more debt by expanding.

But if deregulation reaches the region, TVA's ability to compete—and perhaps survive—could be jeopardized by such a limitation. Also, TVA's ability to import power during its peak winter demands could be impeded.

TVA's detractors would love to see TVA sell itself off piece by piece to investor-owned utilities. Like the tobacco program that McConnell and other Republicans were ready to dismantle last year, TVA is one of the New Deal's enduring legacies.

Protecting consumers from future TVA excesses is a fine idea. Preparing TVA to be plucked by Wall Street is not.

[From the Paducah (KY) Sun, July 7, 1999]

CHANGE NEEDED

TVA MUST PREPARE FOR COMPETITION

During the 1930's and 1940's, the Tennessee Valley Authority made its considerable reputation by delivering low-cost power and an array of other services to people living in the economically depressed Tennessee Valley. Now that paternalistic reputation is receding into history as the 6-year-old government corporation struggles with a heavy debt burden the possible end of Federal subsidies for its non-power programs and looming competition from private utilities in a deregulated power market.

In effect, the shoe is on the other foot: Instead of providing special benefits for residents of the Tennessee Valley, the New Deal-era agency is relying on its customers to cushion it against the impact of declining Federal funding and other financial challenges. President Clinton said the era of big government was over; TVA is a big-government dinosaur battling to survive in an environment that's increasingly hostile to its original mission.

TVA has done a great deal for this region, but the authority's management must justify its continued existence as a government-owned utility. The authority cannot expect to protect its far-flung empire by asking its customers to pay higher electric rates than those charged by private utilities. After all, TVA is supposed to serve the public.

U.S. Senator Mitch McConnell recently suggested that the reverse is true—that TVA ratepayers are propping up the agency. McConnell noted that while several leading private utilities in Kentucky have cut their power rates in the past 2 years, TVA has increased rates by 7 percent.

We grew up thinking if you had TVA power, you were lucky, McConnell said. "Unfortunately, the nearly 212,000 Kentucky families in more than 30 counties who receive power from TVA are finding out that's not the case.

The senator wants to subject TVA to the same regulations that apply to private utilities. Last week he introduced a bill that would force TVA to justify its current rates and any proposed future rate increases.

McConnell's frustration with TVA is understandable. The authority is failing to live up to its original mandate to provide low-cost power in the Tennessee Valley. However, the agency's plight is largely the result of factors beyond its control, including, most notably, the precipitous decline in congressional appropriations for TVA non-power programs.

Two numbers stand out: \$222 million and \$7 million. The first is the amount TVA received from Congress in 1980 for navigation flood control, recreation and other non-power functions. The second is the total of non-power funding President Clinton included for TVA in his budget proposal this year.

The Clinton budget eliminates Federal funding for all of TVA's non-power programs, with the exception of operations in the Land Between the Lakes recreation area. Most members of the Republican majority in Congress will be more than happy to honor the president's proposal to zero out funding for TVA's flood control, dam safety and river management duties.

If congressional funding for the non-power programs dries up, TVA ratepayers will have to cover the cost of managing an inland waterway. In every other area of the country, the U.S. Army Corps of Engineers handles this basic Federal responsibility.

Again, this would turn TVA's mission on its head by requiring the authority's ratepayers to help the Federal Government.

It's clear that TVA officials can't turn back the clock to the days when the authority commanded unshakable support in Congress. The obvious reason is that the generally prosperous Tennessee Valley no longer depends on the Federal Government for economic support.

As the 21st century dawns, TVA must prepare for a future in which it will have to compete to survive. The authority can't compete if it continues to carry the burden of non-power programs, in addition to a \$26 billion dent and a hefty bill for compliance with Federal clean air regulations affecting coal-fired power plants.

TVA officials and congressional leaders should begin planning now for a breakup of the agency. The corps of engineers should assume TVA's river management and flood control duties. McConnell and U.S. Representative Ed Whitfield already have tabled the U.S. Forest Service as a possible choice to take over management of the LBL.

These changes would allow TVA officials to concentrate on serving their power customers. A streamlined TVA may be able to survive and even thrive in the future—not as a benevolent government provider but as clean, efficient power company.

The fence that has long separated the Tennessee Valley Authority from the private power producers won't stand much longer. What then for this New Deal dinosaur?

[From Forbes Magazine, May 19, 1997]

THE TENNESSEE VALLEY ANACHRONISM

(By Bruce Upbin)

The Tennessee River traces a blue curve through downtown Knoxville as it flows gently west to the Ohio. From Craven Crowell's wood-paneled office on the twelfth floor of the Tennessee Valley Authority's headquarters building, the bucolic view stretches northeast across the river valley and away to the hazy outline of the Great Smoky Mountains.

About 500 miles away, in Washington, forces are building that threaten to shatter the TVA's peaceful world. A growing number of Congressmen want to privatize this vestige of New Deal collectivism. The \$215 billion electric power business is racing toward deregulation. The \$5.7 billion (annual revenues) TVA is the country's largest single power generator, but in a world of deregulated power, there is no way it can continue to do business as usual.

Craven Crowell, 54, is a former Nashville, TN newspaperman who became TVA's top flack and lobbyist during the 1980s and in 1989 chief of staff to U.S. Senator James Sasser (D-TN). He is determined to keep the TVA firmly in the hands of gov-

ernment. His allies in this quest include his good friend and Tennessee's favorite son, Albert Gore Jr.

"I sort of see TVA as America's Power Company," draws Crowell. A memorable sound bite, but not a particularly truthful one. Although all Americans subsidize the TVA, to the tune of nearly \$4 billion a year, only a handful of Americans—the 8 million people who live inside the 80,000-square-mile area where the TVA is by law the sole supplier—enjoy the cheap power the subsidies buy.

Nor is the TVA's power as cheap, relatively speaking, as it used to be. As the power industry is deregulated, efficient producers can ship—"wheel"—their juice to markets around the country. Example: Nashville residents could purchase electricity from nearby Kentucky Utilities Corp. for about one cent per-kilowatt-hour less than the nickel an hour they must now pay for TVA power. Why don't they? Because current law in effect prevents power from being wheeled into TVA's territory.

The TVA's Depression-era rationale—developing a backward part of America—no longer exists. The region has developed. Yet the TVA continues to enjoy its enormous advantages over investor-owned utilities. As a Federal authority TVA only has to cover its costs. It pairs no Federal or State income or property taxes although it is required to pay 5 percent of revenues (\$976 million this year) to Tennessee and six surrounding States in place of taxes.

Best of all, the TVA can borrow money much more cheaply than investor-owned utilities can. This is not because its balance sheet is strong—in fact its finances are feeble—but rather because creditors believe the U.S. Treasury stands implicitly behind the TVA's debt.

One recent study put the value of all the indirect subsidies to the TVA at \$3.7 billion for 1993. Without these gifts from the Nation America's Power Company would have to charge its customers 3 cents more per kilowatt-hour. That would make its juice almost as expensive as in some of the high-cost northeastern States. Yet the subsidies are now boxing the TVA in. Over the years the authority has abused its access to cheap credit. Thanks primarily to a disastrous nuclear plant construction binge in the 1970's, the TVA now owes \$27 billion. While the typical investor-owned utility pays 16 cents on the revenue dollar to service its debt, TVA pays 35 percent of revenue and 97 percent of operating income. That leaves little room for error and no room to cut rates in a competitive marketplace.

Crowell knows he has to start paying down principal on TVA's Everest of debt. But how? And at what political cost?

Ratepayers in the valley know that Crowell is now mulling a rate increase as high as 10 percent. But raising rates will weaken Crowell's case that only as a government-owned utility can the TVA carry on the job of providing cheap power to an area that needs to attract investment and jobs.

Crowell also wants to attack the debt problem by selling some of TVA's power to other markets. But the cost of going down that road is to reopen the hoary question of how far the subsidized TVA should be allowed to compete against investor-owned utilities.

In 1959 the TVA wanted to expand its power program without the bother of asking Congress for appropriations every time. The TVA won permission from Congress to issue bonds. But for the privilege it had to agree not to sell power outside its existing operating area. A fence went up that exists to this day.

The fence was originally meant to protect private utilities from competing against the VA's federally subsidized power. But in the last few years, as private producers have grown more efficient, the fence has been left up to protect the TVA from the most efficient of the private producers. The Energy Policy Act of 1992 forced all utilities to open up their transmission lines and wheel wholesale power into their areas from competitors. One utility was explicitly exempted from this provision of the 1992 law: the TVA.

In effect, that exemption makes it impossible for customers inside the fence—the city of Nashville, say—to drop the TVA and buy its power from nearby Kentucky Utilities Corp., even though KU's customers pay about 20 percent less for their juice. The only way a competitor can market electricity in TVA's territory is to build in its own transmission lines. The cost of doing that would, of course, eliminate the cost differential.

But the fence is rickety and Crowell knows it. "The fence no longer makes sense," he told a gathering of public power executives 2 years ago. "And when it does come down, competition will be a two-way street, and TVA will once again have the freedom to compete anywhere in the country."

The fence is developing holes. Last year TVA started selling some cheap power to a marketing unit of Louisville Gas & Electric. Southern Company promptly sued to stop TVA from selling the discount juice to a competitor. Southern won—for a

time the fence held. But last April Southern caught TVA outside the fence again and is now back in court.

The TVA has been only partially successful in using the fence to keep competitors out. It recently suffered what may prove a very significant defeat in the little city of Bristol, in the southwest corner of Virginia, on the edge of TVA's territory. Worried about the fence coming down and its customers escaping, in 1989 TVA began forcing its 160 distributors to sign 10-year contracts locking them into the TVA grid. Bristol refused to sign and later, in 1995 when its original 20-year contract was up, agreed instead to a 30-month extension.

Figuring that TVA'S debt load could only push up rates, Bristol began shopping around and found 18 investor-owned utilities that would match or beat TVA rates: The city informed TVA that starting in January 1998, it will buy its power from Cincinnati-based Cinergy, Corp., one of the country's most efficient utilities. Cinergy plans to wheel in the power over lines owned by American Electric Corp. if it cannot reach an agreement with TVA by June. With Cinergy, Bristol expects to shave its \$22 million a year bill by \$7 million per year for the next 7 years.

"Bristol only buys 140 megawatts, but it's a stalking horse for other distributors," says Robert Gross, the energy consultant who helped Bristol with its bidding process.

The TVA wins some battles, too. In December 1993, 4-County Electric Power Association, a co-operative in Columbus, Miss., told TVA it wanted to end its contract to buy TVA power. 4-County got 30 bids, the best of which would have cut its TVA bill by \$63 million over 7 years.

But at the time TVA was negotiating a long-term power purchasing contract for a new coal-burning plant that would provide hundreds of \$12-an-hour jobs for impoverished Choctaw County, right in 4-County's backyard. TVA told 4-County that if the town went elsewhere for power, the TVA would reconsider building the plant. Today 4 County is back inside the TVA fence, paying more than it has to for power.

Grouses Earl Weeks, chief executive officer of 4-County Electric Power, "When TVA gets through a 10 percent rate increase this year, there's no question they're going to incur the wrath of Congress."

Crowell already has. In March he appeared before a congressional subcommittee to do some appropriations horse-trading. "Keep your hands off my river!" Representative Harold Rogers, a Republican from Kentucky, bellowed at Crowell when the TVA chairman proposed that TVA hydroelectric engineers could do a better job than the Army Corps of Engineers managing nine hydroelectric dams on the Cumberland River.

Other Congressmen piled on. New Jersey Republican Rodney Frelinghuysen's aides had discovered TVA ads running in New Jersey newspapers, using cheap power to lure New Jersey businesses to the Tennessee Valley. Frelinghuysen didn't think New Jerseyans should be subsidizing an attack on the State's job base. He introduced a bill (H.R. 677) that would end over \$100 million of TVA appropriations immediately.

Momentum to sell the TVA is building. The small Alaska Power Administration will be sold near the end of the year to State and city agencies for an estimated \$80 million. Bill Clinton's 1996 budget included the sale of four more of the government's six Power Marketing Administrations, for \$4.4 billion—excluded was the Pacific Northwest's Bonneville Power Authority, which Congressman Scott Klug (R-Wis.) figures would bring \$7 billion. The plan died, but this year Arizona Republican Congressman John Shadegg reintroduced legislation to sell the PMAs.

The TVA is a power generator, not a power marketing agency, but Crowell is nevertheless fighting the privatization pressures on several fronts. Appealing to the Al Gore Jr. political left he asks: "If you drive to the bottom line and all you're interested in is making money, who's going to worry about the environment and universal access [to power]?"

To which House Republican Dan Schaefer scoffs: "Reliability is a red herring used by monopoly utilities to stall the inevitable approach of true competition." Crowell also conveniently ignores the fact that some of the TVA's harshest critics over the years have been the environmentalists. On another tack to save the TVA as he knows it, Crowell is trying to make the authority look more like a private business. He and his predecessor, Marvin (Carvin) Runyon, now head of the U.S. Postal Service, deserve credit for cutting \$800 million from the TVA's annual operating budget since 1988, mainly by slashing payrolls from 34,000 to 16,000.

Making a virtue of necessity, Crowell in 1995 imposed a debt limit on the TVA of \$28 billion. Next year still be the first in 35 years TVA won't increase its debt.

At the end of the day, however Crowell knows that his best defense against privatization is the TVA's \$27 billion mountain of debt, nearly all of it held by institutions and individuals. His threat: If TVA were privatized—and absent a U.S. Treas-

ury guarantee of some kind—its paper would collapse in price. Its cost of capital would nearly double, probably bankrupting the TVA.

Glowers Crowell, shrewdly playing up the implicit, but not binding, U.S. backing of TVA's debt: "If you did anything legislatively that put TVA in a position where it would not succeed, then you end up putting it in a bailout position in which the taxpayers would then have to pick up the debt."

In fact, privatizing the TVA would not be nearly as painful as Cromwell would have one believe. Against its liabilities, and \$6.3 billion worth of idle nuclear power plants, it also has some very valuable assets. The crown jewels are TVA's mostly written-off coal-fired and hydroplants, worth roughly \$8.5 billion on the open market. There is also \$5 billion in so-called proprietary capital, similar to a private company's retained earnings account.

Craven Crowell doesn't buy this. He thinks the TVA is too deeply embedded in American politics and economics for it to be ripped out and told to stand on its own. He concludes his case with a broad smile on his face: "You can't ignore us, you can't leave us behind, you can't break us up, and you can't sell us."

On the other hand, hasn't the past decade taught that when change starts to blow through countries and industries, not even the toughest old dinosaurs can find shelter

Our bet: The TVA'S days are numbered.

**PADUCAH POWER SYSTEM'S POSITION
ON ISSUES RELATING TO RESTRUCTURING OF
ELECTRIC UTILITIES
PRESENTED BY: DON FULLER, PE, GENERAL MANAGER
OCTOBER 6, 1999**

I. TVA LEGAL STATUS

REPEAL TVA'S STATUS AS A STATE REGULATORY AUTHORITY.

SUBJECT TVA, AS A TRANSMITTING UTILITY, TO FPA WHOLESale TRANSMISSION SERVICE OBLIGATIONS IMPOSED ON PUBLIC UTILITIES.

SUBJECT TVA TO FERC JURISDICTION OVER ITS WHOLESale RATES AND STRANDED COSTS.

II. WHOLESale TRANSMISSION ACCESS

SUBJECT TVA'S TRANSMISSION RATES, TERMS, AND CONDITIONS TO FERC JURISDICTION INCLUDING THE OPEN ACCESS REQUIREMENTS OF FERC ORDER NO. 888.

III. ANTI-CHERRY PICKING (REPEAL)

FPA MANDATES THAT FERC CANNOT FORCE TVA TO PROVIDE TRANSMISSION SERVICES TO ANOTHER ENTITY IF THE POWER WILL BE CONSUMED WITHIN THE TVA FENCE. WITHOUT THE REPEAL OF THIS PROVISION WHOLESale ELECTRIC COMPETITION WILL NEVER BE POSSIBLE IN THE TENNESSEE VALLEY.

IV. "FENCE" (REPEAL)

FPA AND TVA ACT PREVENT TVA FROM MAKING CONTRACTS HAVING THE EFFECT OF MAKING TVA OR ITS DISTRIBUTORS A SOURCE OF POWER SUPPLY OUTSIDE THE "FENCE." WHOLESale ELECTRIC COMPETITION IN THE TENNESSEE VALLEY WILL NEVER BE POSSIBLE UNLESS THESE PROVISIONS ARE REPEALED.

V. REVIEW OF TVA TRANSMISSION RATES

S.1323 SEC 2 (A) MAKES TVA A PUBLIC UTILITY, GIVES FERC AUTHORITY OVER TVA TRANSMISSION SERVICES. FERC HAS JURISDICTION OVER RATES, TERMS AND CONDITIONS OF PUBLIC UTILITIES TRANSMISSION SERVICE PURSUANT TO FPA.

VI. REVIEW OF TVA WHOLESALE POWER RATES

FERC SHOULD HAVE AUTHORITY TO ESTABLISH JUST AND REASONABLE RATES FOR TVA'S WHOLESALE ENERGY SALES. TVA SHOULD BE SUBJECT TO SAME FERC AUTHORITY TO REGULATE WHOLESALE POWER RATES TO WHICH PUBLIC UTILITIES ARE SUBJECT.

VII. WHOLESALE STRANDED COST RECOVERY BY TVA

ALLOW TVA TO RECOVER STRANDED COSTS, AS DETERMINED BY FERC, FROM CUSTOMERS THAT TERMINATE THEIR LONG-TERM POWER CONTRACTS WITH TVA. FERC ORDER NO 888 HAS A MOST FAIR AND EFFICIENT MECHANISM FOR CALCULATING AND ASSESSING WHOLESALE STRANDED COSTS.

VIII. MANDATORY RETAIL CHOICE

WHILE NOT ADDRESSED BY S.1323 (MCCONNELL BILL) PPS OPPOSES FEDERALLY MANDATED RETAIL CHOICE.

IX. REFORM OF LONG-TERM TVA CONTRACTS WITH DISTRIBUTORS

ALLOW DISTRIBUTORS TO TERMINATE OR REDUCE PURCHASES UNDER EXISTING WHOLESALE ELECTRIC ENERGY CONTRACTS WITH TVA ON TWO YEARS' NOTICE.

X. REGULATORY AUTHORITY BY TVA OVER DISTRIBUTORS

TRANSFER REGULATORY AUTHORITY FROM TVA TO DISTRIBUTORS LOCAL GOVERNING BODIES.

XI. STRANDED COST RECOVERY BY DISTRIBUTORS

PPS FAVORS RECOVERY OF RETAIL STRANDED COSTS AS DETERMINED BY THE GOVERNING BODY OF THE DISTRIBUTOR.

XII. ANTI-TRUST

MAKE FEDERAL ANTI-TRUST LAWS APPLICABLE TO TVA BUT INSULATE TVA FROM CIVIL DAMAGES LIABILITY FOR ANTI-TRUST VIOLATIONS THE SAME AS OTHER GOVERNMENTAL ENTITIES.

XIII. RETAIL SALES

PPS BELIEVES TVA SHOULD BE ALLOWED TO CONTINUE SERVING DIRECT SERVE RETAIL CUSTOMERS WITHIN A DISTRIBUTORS SERVICE AREA THAT ARE UNDER CONTRACT PRIOR TO ENACTMENT OF FEDERAL LAW. PPS OPPOSES FUTURE RETAIL SALES OF TVA AND DIRECT COMPETITION WITH RETAIL DISTRIBUTORS REGARDLESS OF LEVEL OF PURCHASES FROM TVA BY DISTRIBUTOR.

XIV. WHOLESALE SALES OUTSIDE THE VALLEY

PPS BELIEVES TVA SHOULD BE ALLOWED TO SELL AT WHOLESALE BEYOND THE VALLEY AND OPPOSE LIMITING SUCH SALES TO "EXCESS ENERGY." TVA'S PARTICIPATION IN COMPETITIVE MARKETS SHOULD NOT BE RESTRICTED. REVENUES GENERATED BY ANY TVA POWER SALES WILL MITIGATE TVA'S STRANDED COSTS.

XV. NEW GENERATION CAPACITY

PPS BELIEVES TVA SHOULD NOT BE LIMITED IN THEIR ABILITY TO CONSTRUCT OR ACQUIRE NEW GENERATION FACILITIES. TVA SHOULD BE PERMITTED TO PARTICIPATE IN THE COMPETITIVE MARKETS AND NOT BE RESTRICTED.

 RESPONSES BY DON FULLER TO ADDITIONAL QUESTIONS FROM SENATOR MCCONNELL

Question 1. Do you support FERC jurisdiction over TVA's wholesale sales of electricity? Would it make any sense for Congress to give FERC jurisdiction over TVA's wholesale sales outside, but not inside, the Tennessee Valley?

Response. I support FERC jurisdiction over TVA's wholesale sales of electricity. For TVA to be both a supplier and regulator is not sound public policy and very much like the "fox guarding the hen house." It only makes good sense for FERC to have jurisdiction over TVA's wholesale sales both inside and outside the Tennessee Valley.

Question 2. Do you think that mandatory arbitration of disputes over TVA rate increases is a good idea? If not, why not?

Mandatory arbitration of disputes over TVA rate increases is not a good idea. Arbitration would be a very lengthy and costly process. FERC is an established entity that is best suited to reviewing and approving TVA's wholesale rates.

Question 3. Isn't alternative dispute resolution at FERC an option for those distributors who would prefer to arbitrate rate disputes?

Response. Alternative dispute resolution under FERC oversight is a viable method for distributors preferring to arbitrate rate disputes. Other arbitration or methods of resolution could be subject to persons or entities that may not fully understand all the issues in rate structures.

Question 4. Do you think that the statutory barriers to wholesale competition in the Tennessee Valley should be repealed?

Response. Statutory barriers to wholesale competition in the Tennessee Valley should be repealed. This would give distributors in the valley access to competitive wholesale markets that exist in most of the country.

Question 5. When will your existing TVA contract terminate? Do you support legislation that would permit you to terminate before then?

Response. Paducah Power System is signatory to a "5 plus 5" all requirements contract with TVA. This contract became effective October 1, 1997. Under the terms of the contract, notice of intent to cancel can be given at the end of the fifth year, with a 5-year notice. If this is done, our contract will terminate September 30, 2007. At this time, no stranded costs will be owed. We do support legislation that would permit earlier termination.

Question 6. Should Congress restrict TVA's ability to construct or acquire new generation facilities? If so, what kind of restrictions would be appropriate? Should Congress require that the customer on whose behalf the facilities are constructed or acquired commit to bear the costs of such construction? Should it be left to TVA to determine when new generation facilities are "necessary" to serve distributors?

Response. TVA should have the ability to function like and under the same terms and conditions as any other utility. (i.e.—Under FERC jurisdiction.) This should be part of the final restructuring bills.

As an interim measure, customers on whose behalf the facilities are constructed or acquired should bear the costs. The decision to add new generation or facilities should be based on good engineering and business practices. Under FERC jurisdiction those "reasons" would have to be shown. Prior to action placing TVA under FERC jurisdiction, if TVA adds generation or facilities to serve Bowling Green, for example, Paducah should not have to help pay for that expenditure.

Question 7. Should TVA be permitted to expand any further into the retail business than it already has? Doesn't permitting TVA to compete for retail customers with distributors that purchase more than 50 percent of their power from wholesale suppliers other than TVA penalize distributors who take advantage of the competitive market to obtain a majority of their requirements?

Response. TVA should not be permitted to expand any further into retail business. Permitting TVA to compete for retail customers with distributors that purchase less than 50 percent of their power from TVA would indeed penalize those distributors taking advantage of the competitive market. An exception to this would be where a distributor could not or did not want to serve a particular large retail load then permission could be granted by the distributor for that load to be served directly.

Question 8. Paducah Power System is uniquely located with other power suppliers nearby. Do these neighboring suppliers offer more competitive rates than TVA?

Response. Paducah Power System is located in an area surrounded by an electric cooperative not served by TVA. Additionally there are two power suppliers besides TVA with transmission lines routed through the area that Paducah Power System currently serves. The wholesale rates of both these suppliers are presently less than TVA's.

Question 9. Currently, what opportunity do you have, or do your customers have, to challenge the rates imposed by the TVA Board? Do you have any opportunity to review or challenge any of the charges TVA has incurred?

Response. The only method to challenge rates imposed by the TVA Board is through the Tennessee Valley Public Power Association. This is an association made up of distributors of TVA power. The Rates and Contracts Committee of this association typically negotiates or discusses rates with TVA and then brings their recommendations to the membership for a vote. I am not sure what the next move would be if the membership did not approve a rate increase.

Question 10. Memphis and Knoxville have been outspoken in their differences with TVA. How does your position compare with these two larger utilities? Are you aware of distributors who support these views but are fearful of speaking out against TVA?

Response. I was not aware of the position taken by Memphis and Knoxville until the week of October 3, 1999. After reading their position papers I find Paducah Power System's position to be very similar. Yes I am aware of distributors that hold most of the same views as Paducah but are fearful of speaking out against TVA.

Question 11. Do you have a clear understanding of how TVA intends to calculate stranded costs? Are you aware of any independent review of what TVA intends to collect through stranded costs? Could TVA's allocation of stranded cost adversely affect your ability to seek the purchase of lower cost power from another generator, like Kentucky Utilities?

Response. Paducah Power System does not have any understanding of how TVA intends to calculate stranded costs. I am not aware of any independent review of what TVA intends to collect through stranded costs. TVA's allocation of stranded cost could adversely affect our ability to seek the purchase of lower cost power.

Question 12. What type of notice has TVA provided to you about its plans to recover stranded costs if you attempt to leave TVA? Are you confident that you will only be billed for charges incurred by Paducah Power System?

Response. Paducah Power System's only notice from TVA concerning stranded costs is that associated with our current contract. (i.e.—There will be no stranded costs if we stay the term of the contract that expires September 30, 2007.) If the decision were to leave earlier, I am not confident Paducah would only be billed for charges incurred by us.

Question 13. Some TVA distributors have advocated for a third party arbitrator. Are you aware of individual customers who would be party to this arbitration? Do you know if this arbitration would require TVA to open up its books so that customers could view all of TVA's rates and charges?

Response. I can only guess who some of the individual distributors might be that would be party to arbitration. I have no knowledge as to requirements for TVA to open up its books so that customers could view all of TVA's rates and charges.

Question 14. Does TVA seek your input on the construction of new generation facilities?

Response. TVA has never sought my input on the construction of new generation facilities.

Question 15. Over the next 5 years, TVA's 211,427 Kentucky rate payers will pay \$250 million more than if they were customers of Kentucky Utilities, which is FERC regulated. Please tell the committee what impact FERC regulation of TVA would have on your utility.

Response. Regulation of TVA by FERC would not have an immediate effect on Paducah Power System. The longer term impact will be, in my opinion, to help keep wholesale rates down by controlling unnecessary additions and expenses not directly related to serving energy to the distributors.

RESPONSES BY DON FULLER TO ADDITIONAL QUESTIONS FROM SENATOR INHOFE

Question 1. Please detail on a kilowatt/hour basis how rates of Paducah Power compare with rates of TVA.

Response. TVA is the supplier of power to Paducah Power System. For the billing period August 24, 1999 through September 23, 1999, Paducah Power paid TVA 5.017 cents/KWH. This, for example, compares to a Kentucky Utilities wholesale rate of 2.9 cents/KWH.

Question 2. Do you or any of your customers have any opportunities to challenge the rates imposed by the TVA Board?

Response. The only method to challenge rates imposed by the TVA Board is through the Tennessee Valley Public Power Association. This is an association made up of distributors of TVA power. The Rates and Contracts Committee of this association typically negotiates or discusses rates with TVA and then brings their recommendations to the membership for a vote. I am not sure what the next move would be if the membership did not approve a rate increase.

Question 3. Utilities in Memphis and Knoxville have been extremely vocal in their criticism of TVA. Is their position unique to these larger utilities? Do you agree with their view of TVA?

Response. I was not aware of the position taken by Memphis and Knoxville until the week of October 3, 1999. After reading their position papers, I find Paducah Power System's position to be very similar. I don't think their position is unique to larger utilities.

Question 4. Has TVA provided you any type of notice or information about its plans to recover stranded costs should you attempt to leave TVA? Please provide any information which you will use to verify.

Response. Paducah Power System does not have any understanding of how TVA intends to calculate stranded costs. I am not aware of any independent review of what TVA intends to collect through stranded costs. TVA's allocation of stranded cost could adversely affect our ability to seek the purchase of lower cost power.

Paducah Power System's only notice from TVA concerning stranded costs is that associated with our current contract. (i.e.—There will be no stranded costs if we stay the term of the contract that expires September 30, 2007.) If the decision were to leave earlier, I am not confident Paducah would only be billed for charges incurred by us.

Question 5. In disputes with TVA, some distributors have advocated a third party arbitrator. Have you been approached by customers who would participate in such

a system? If arbitration should occur, should TVA be required to open up its books so that customers could verify rates?

Response. I can only guess who some of the individual distributors might be that would be party to arbitration. TVA should be required to open up its books so that customers could view all of TVA's rates and charges.

Question 6. Does TVA seek comments from other suppliers on the construction of new generation facilities?

Response. As a distributor, TVA has never sought my input on the construction of new generation facilities. I have no knowledge if TVA seeks comments from other suppliers.

Question 7. Please detail what effects FERC regulation of TVA would have on your utility.

Response. Regulation of TVA by FERC would not have an immediate effect on Paducah Power System. The longer-term impact will be, in my opinion, to help keep wholesale rates down by controlling unnecessary additions and expenses not directly related to serving energy to the distributors.

STATEMENT OF ROBERT M. HEWETT, PRESIDENT, KENTUCKY UTILITIES COMPANY, ON BEHALF OF TVA WATCH

Summary

The debate over TVA's future in an increasingly competitive electric power market is a difficult one. However, it is one that must be confronted and dealt with fairly. TVA Watch believes Congress must remain alert to the problem that led to the creation of the TVA "fence" in 1959. The problem was, and remains, unfair competition by the Federal Government.

Without the "fence," TVA would be able to gain market share not by virtue of its being the most efficient supplier, but because it could undercut the market based upon its governmentally-granted benefits. TVA has the ability to set its own wholesale and retail rates, is exempt from anti-trust laws and makes only "token" payments in lieu of taxes to local governments. No other entity in the country even comes close to having this type of authority or license. Yet, TVA has amassed a \$27 billion long-term debt, far in excess of any comparably sized private sector utility. Moreover, TVA's progress in dealing with this enormous debt has been inadequate and has resulted in a sizeable potential liability for U.S. taxpayers.

The fact that TVA has such powerful tools while other utilities do not is the very reason Congress created the "fence" in 1959. The fact that TVA's financial health is impaired because of its long-term debt is another reason Congress should not increase the risk to U.S. taxpayers by lowering the "fence" without first bringing about fundamental reform to TVA. These concerns are especially valid today because, during the past 4 years, TVA has been carrying out a strategy to undermine and eliminate the "fence." As a result, several companies in TVA Watch have had to sue TVA to enforce the 1959 law that keeps TVA inside the "fence."

TVA Watch believes the following ground rules that apply to TVA's potential competitors must apply to TVA itself if the "fence" is to be removed:

1. Anti-trust laws that apply to private-sector utilities must apply with the same force and effect to TVA.
2. TVA must come under the jurisdiction of the Federal Energy Regulatory Commission (FERC) to the same degree as other utilities. This includes regulation not only of TVA's transmission system, but its power sales practices.
3. TVA must not be allowed to build new or expanded generation resources with the wide range of subsidies that are denied other utilities.
4. TVA must bear the same Federal, State and local tax burdens as other utilities.
5. TVA should not have preferential access to power from other Federal facilities at rates below fair market value.
6. TVA's exemption from open access transmission system requirements should be repealed.

Introduction

Mr. Chairman and Members of the Committee: my name is Robert M. Hewett. I am President of Kentucky Utilities Company of Lexington, Kentucky. Kentucky Utilities is a subsidiary of LG&E Energy Corporation, a diversified energy services company with businesses in power generation and project development; retail gas and electric utility services; and asset-based energy marketing. In addition to Kentucky Utilities Company, which serves 77 Kentucky counties and five counties in Virginia, LG&E also owns and operates Louisville Gas and Electric Company, which serves 16 Kentucky counties.

LG&E also is a member of TVA Watch, a coalition of investor-owned utilities operating in areas adjacent to the Tennessee Valley Authority (TVA). TVA Watch is a political and judicial coalition of shareholder-owned utilities that was formed to serve two public policy functions: First, to ensure that TVA complies with the TVA Act. Second, to promote policy discussion regarding the proper role of TVA in a competitive marketplace. In addition, TVA Watch supports efforts to bring meaningful reform to TVA as America's electric power industry evolves into a more competitive market.

We appreciate your invitation to share with this committee the views of TVA Watch about the role of the Tennessee Valley Authority in a changing electric power industry.

In considering the future of TVA, there are three issues facing Congress. First, should TVA be allowed to compete against other utilities outside the fence that has limited the scope of its electric power operations since 1959? Second, if the answer to the first is affirmative, then under what terms and conditions should TVA be allowed to compete? Third—and we consider this to be an especially important one regardless of whether TVA is allowed to compete outside its fence—is TVA doing enough to address its poor financial condition resulting from its massive \$27 billion debt?

These issues are difficult and must be approached with great care. But, before sharing the views of TVA Watch with this Committee, I want to emphasize at the outset that my company and others in TVA Watch have worked well with TVA under a provision of the 1959 law that allows our power grids to be interconnected for purposes of maintaining reliability and exchanging surplus power. Recent evidence of this positive working relationship came during this summer's heat wave when all of us worked to exchange power that kept our systems running. However, when we disagree with TVA, as we do in the case of how TVA should be allowed to compete with other utilities, we do so in the spirit of constructive debate.

To assist this Committee in evaluating TVA's future role, we should be mindful of where TVA came from and what it has become. As originally enacted in 1933, the TVA Act did not authorize TVA to build power plants or to sell power. This authority was added a few years later. TVA is merely "authorized," rather than instructed, to build power plants and maintain a power function. However, what began as merely a side function has become TVA's core business—a \$30 billion power utility enterprise that has become, by far, the biggest part of its business.

Until 1959, TVA was required to come to Congress for direct appropriations to pay for the growth of its power business. In 1959, Congress agreed to grant TVA the ability to issue revenue bonds to finance the growth of its generation business. In so doing, however, Congress erected the fence around TVA so that TVA could not use its unique powers in direct competition with other utilities in its region. Senator Jennings Randolph, the dean of the West Virginia Congressional delegation and a veteran of the New Deal Congress that created TVA, predicted in 1959 that "when memories have dimmed and new faces have come upon the scene" the purposes of the TVA Fence law might be lost.

As Senator Randolph stated in 1959, "it would be inadvisable to permit excessive competition by TVA to encroach on the areas served by . . . investor-owned public utilities, to siphon off their customers and to destroy the value of their properties."

Until recently, TVA continually reassured Congress about the value and importance of the fence. In 1979, for example, Congress amended the TVA Act to raise TVA's debt ceiling from \$15 billion to \$30 billion. (In 1959, TVA's debt limit was less than \$1 billion!) The increase was actively championed by TVA. However, in response to concerns that it had aspirations to expand the scope of its service territory, TVA repeatedly stated it had no desire to compete in bulk power markets outside its territory, as demarcated by the 1959 Bond Act. Congress took TVA at its word. The Senate Report accompanying Public Law 96-97, stated:

"In reporting (the debt ceiling increase bill), the committee (Senate Environment and Public Works) is mindful of the repeated assurances of the present Board of Directors of TVA that the Corporation has no intention of acting in any manner, directly or indirectly, to expand its service area outside the boundary as fixed by the TVA Self-Financing Act of 1959. The utilities whose service areas adjoin the service area of TVA continue to need to be entitled to the protection of the provisions of the 1959 Act. In now acting to increase TVA's debt authority from \$15 billion to \$30 billion, the committee reaffirms the provisions of the 1959 Act and accepts the assurances of TVA that it will continue to abide by those provisions."

Congress believed that because the rules for government and private utilities were different, TVA should only be allowed to sell or deliver power to two broad classes of recipients, and under limited circumstances:

“to local wholesale distributors within the area for which TVA was the primary source of electric power supply in July of 1957, and to certain end-users to whom it sold power at that time; and to electric utilities with which it was interconnected in July of 1957 for the continued cooperative ‘exchange’ of power between neighboring utility systems.”

TVA’s Departure from Its Agreement Not to Compete

In 1995, however, TVA departed from its previous pledge that it had no intention to compete outside the fence. TVA began pursuing a strategy to undermine the 1959 law so that it could compete against other utilities beyond the fence. For example:

In April 1995, TVA released a study stating that TVA is ready for competition.

In 1995, TVA began to advertise outside its service territory.

In 1996, TVA undertook steps to sell power outside the fence in violation of the 1959 Bond Act. This prompted the creation of TVA Watch and forced members of TVA Watch to initiate three lawsuits against TVA to force compliance with the law. TVA Watch member companies have prevailed in each action. This recent experience convinces us that continued vigilance over TVA is necessary to assure that the interests of consumers and taxpayers are protected.

If the Fence is to Come Down, There Must be a Level Playing Field

TVA Watch is mindful that some of TVA’s distributors want Congress to bring more competition into the electricity industry and that removing the fence should be part of legislation to accomplish that goal. TVA Watch believes the desire on the part of TVA’s customers should be taken seriously, but offers two observations: First, current law gives TVA the right to permit wholesale competition in the Valley and allows TVA means to adequately mitigate potential stranded costs by selling surplus power on a limited basis to neighboring utilities. Second, as Congress considers electricity restructuring legislation, issues surrounding the TVA—its huge debt, substantial subsidies, exemption from basic laws, artificial competitive advantages, and its lack of accountability—must be addressed before the fence can come down. Failure to do so will simply undermine the primary goal of fair and efficient competition.

In setting the ground rules by which TVA could be allowed to compete, TVA Watch believes the following rules that apply to TVA’s competitors must apply to TVA itself:

1. Anti-trust laws that apply to private-sector utilities must apply with the same force and effect to TVA.
2. TVA must come under the jurisdiction of the Federal Energy Regulatory Commission (FERC) to the same degree as other utilities. This includes regulation not only of TVA’s transmission system, but its power sales practices.
3. TVA must not be allowed to build new or expanded generation resources with the wide range of subsidies that are denied other utilities.
4. TVA must bear the same Federal, State and local tax burdens as other utilities.
5. TVA should not have preferential access to power from other Federal facilities at rates below fair market value.
6. TVA’s exemption from open access transmission system requirements should be repealed.

We urge Congress to resist the temptation to pick and choose from among this list. The issue is whether or not we are going to have competition where TVA competes under the same rules as its potential competitors. It is not good enough to pick a few rules and conclude it’s “close enough.” Our position is that if TVA doesn’t want to play ball under the same rules as everyone else, they should not be allowed into the competitive supply game. Close enough is not good enough.

TVA Wants Its Own Rules

TVA, however, strenuously disagrees that it must play by the same rules as other utilities. TVA argues it can compete fairly under a special set of rules, especially when it comes to setting its own electricity prices. TVA wants to retain its ability to set its own prices. In a December 31, 1998 letter to the Department of Energy the Chairman of TVA argues the TVA Board should retain sole control over setting its power rates rather than having its decisions reviewed by the Federal Energy Regulatory Commission (FERC). The letter said in part:

“We see no reason why another set of presidential appointees should be designated to do the job we were appointed to do. . . . The ability of the TVA Board to raise and lower rates as necessary is vital to TVA’s financial health and its ability to keep the region’s power supply costs as low as feasible. The reversal of a TVA Board decision by FERC could mean that TVA does not collect enough revenue to meet its financial obligations to bondholders, operate the power system economically, or ensure the safe operation of its nuclear plants. . . . TVA is not a private

power company, and one cannot ascribe to it the same motivations that drive private power companies—to increase market share and profits.”

We would point out that the investor-owned utilities in our coalition have been subject to Federal and State regulation for years and have always met their financial obligations.

Numerous “electricity restructuring” bills with provisions dealing with TVA have been introduced. TVA Watch commends Senators McConnell and Bunning for introducing S. 1323, the “TVA Customer Protection Act of 1999,” along with Representative Baker’s House companion bill, which both would go a long way toward assuring that any competition between TVA and other utilities would be conducted fairly and equitably.

TVA, however, has endorsed electricity restructuring legislation proposed earlier this year by the Clinton Administration (H.R. 1828/S. 1047). The Administration’s bill would permit TVA to issue more debt to build and operate facilities anywhere in the country with only superficial changes in the rules that currently govern TVA. U.S. taxpayers would be placed at greater risk for any TVA business activity and consumers would be denied the benefits of fair competition.

The provisions in the Administration’s bill dealing with TVA are largely derived from a 1998 report prepared by the U.S. Department of Energy following the completion of a special task force, the Tennessee Valley Electric System Advisory Committee (TVESAC). This advisory committee consisted of several interests, including TVA, TVA Watch, labor, environmental and consumer groups. While TVA Watch was pleased to participate in the TVESAC process, we emphatically disagree with assertions by TVA that the report (Report of the Tennessee Valley Electric System Advisory Committee, U.S. Department of Energy, March 31, 1998) represents a “consensus” among the various interests. If anything, the report points out the fundamental disagreements over how TVA should be regulated in an increasingly competitive market.

TVA Watch also wishes to state its deep concern about a legislative draft currently under consideration before the House Energy and Power Subcommittee. While the TVA title in that draft appears to create a more level playing, it really does not. The draft calls for certain regulation of TVA by the FERC and application of some antitrust laws. However, the draft contains a “savings clause” that none of these provisions could be implemented in a way that would undermine TVA’s ability to pay its bondholders. This clause, in effect, “swallows” the other provisions and renders them useless.

We would point out that even though TVA supports the Administration’s bill to remove the fence and allow TVA to compete with these lenient rules, TVA itself recently has stated it intends only to serve the electricity needs inside the Tennessee Valley. As we have stated above, the experience of the past means we should continue to monitor TVA’s activities closely. We also should be frank to say that if TVA is permitted to compete outside the fence under terms such as those in the Administration’s bill, the result would be to allow a financially impaired agency of the Federal Government to compete against other utilities under one set of rules while those other utilities would have to operate under more stringent rules. Not only would consumers be denied the economic benefits of fair competition, taxpayers would be at risk for even more debt.

TVA Is In Poor Financial Shape to Compete

Frankly, we believe TVA should concentrate on getting its financial house in order before—not after—it worries about whether it will be able to compete under its own set of lenient rules.

Since 1959, TVA has used its free reign to grow rapidly, particularly in the late 1960’s and 1970’s, obtaining congressional approval to increase its debt cap a number of times, from the original \$750 million to the \$30 billion authorization that exists today. TVA’s financial performance has not been impressive. In a 1995 Report to Congress (GAO/AIMD/RCED-95), the GAO discussed TVA’s lack of financial stability:

“TVA is \$26 billion in debt and has invested \$14 billion in nonproductive nuclear assets (called ‘deferred assets’) that are not included in its electricity rates. As a result, TVA has far more financing costs and deferred assets than its likely competitors have, which gives TVA little flexibility to meet competitive challenges. To the extent that TVA cannot compete effectively and improve its financial condition, the Federal Government is at risk for some portion of TVA’s debt. . . . While no cash-flow crisis exists today, GAO believes that TVA’s financial condition threatens its long-term viability and places the Federal Government at risk. Resolving TVA’s financial problems will be costly and require painful decisions.”

TVA issued a "10-year plan" in July of 1997. The 10-year plan called for lowering TVA's fixed costs by reducing its outstanding debt by about one-half, to about \$14 billion by 2007—about \$1.4 billion per year. The plan also provided for rate increases whereby TVA could start recovering from its customers nearly all of its \$8.5 billion in deferred, nonproductive, assets. (These assets consist of nonproducing nuclear plants and other unamortized regulatory assets. As reported by GAO, "the balances of these items were \$6.3 billion and \$2.2 billion, respectively.")

TVA Watch was pleased that TVA issued this 10-year plan because it reflected an admission by TVA that it really has no use for its \$8.5 billion nonproductive assets, and that it will have to amortize the debt associated with those assets at some point. It also reflected an acknowledgment by TVA that it can't sit on its mountain of debt forever, and that it will have to pay down that debt if it wants to be able to compete in the future.

TVA's Debt Reduction Plan Going in Wrong Direction

But it was too good to be true. The GAO (GAO/AIMD-99-142) recently reported that TVA is unlikely to meet the plan's objectives and needs to update its assumptions. Now, what was originally a ten-year plan seems more like a 20 or 40 year plan. TVA expects to end the current fiscal year paying down its debt by \$306 million. This is far short of TVA's needed debt retirement projected to be near the 10-year plan. At the rate of \$300 million per year in debt retirement, it will take TVA over 40 years to reach their stated goal of cutting TVA debt in half.

Moreover, TVA already is already backtracking on its plan to cut its long-term debt in half. In recent weeks, TVA's leadership has issued press statements that they may need to issue up to \$3 billion in additional debt to fund the construction of more power plants. This would run TVA's long-term debt right up to its \$30 billion limit. We submit this is going in the wrong direction.

TVA issues its massive debt in the form of various types of bonds. These bonds are sold to private investors not just in the United States, but around the world, at rates just barely above the U.S. Treasury rate. TVA is able to borrow money at government rates because the investment community is convinced that the Federal Government will bail out TVA, whenever push comes to shove. In an April 28, 1999, statement, Standard & Poor's said:

"The (AAA) rating reflects the U.S. government's implicit support of TVA and Standard & Poor's view that, without a binding legal obligation, the Federal Government will support principal and interest payments on certain debt issued by entities created by Congress. The rating does not reflect TVA's underlying business or financial condition."

TVA does little to dispels the perception held by investors that placing their money in TVA's hands is tantamount to giving it to Uncle Sam himself. In a classic understatement, TVA's Chairman testified before Congress (House Public Works and Transportation Committee, March 9, 1994), ". . . when you start looking at selling bonds, the fact that we're a government agency obviously is a big help."

The faith of the investors in TVA also is founded on the unrestrained ability of the TVA Board to raise electric rates if needed to pay the bondholders. Thus, the financial markets have afforded TVA an investment status equivalent to a government entity with authority to levy taxes. Even though its bonds are not expressly guaranteed by, or obligations of, the Federal Government, TVA's debt obligations nonetheless are viewed as "risk-free."

What If TVA Were Rated As Other Utilities?

What would happen to TVA's debt rating if the Standard & Poor's benchmarks that are applied to investor-owned utilities were applied to TVA? TVA's rating would be lower than that assigned to junk bonds. For example, with a debt to capital ratio of more than 80 percent, TVA's rating would be lower than "B" while most investor-owned utilities have ratings of "A" or "BBB" with debt to capital ratios of about 50 percent. Also, with a pre-tax interest coverage ratio of 1x, TVA's rating would be lower than that assigned to a typical investor-owned utility. Still, because of its "AAA" rating resulting from its status as an agency of the Federal Government, TVA has a significant cost of capital advantage over its investor-owned neighboring utilities. TVA, therefore, is able to borrow funds at lower interest rates than other utilities because of that higher credit rating.

It is not surprising that TVA, whose capital structure is otherwise exceedingly risky (87 percent debt), can obtain such a low cost of capital relative to most investor-owned electric utilities. TVA's average cost of money is lower than the average for all IOUs, even though the financial conditions of private utilities are generally healthier. TVA also has enjoyed the financial advantages of avoiding writing-off certain nonperforming assets.

If TVA were regulated as an investor-owned utility, it is likely that under conditions of the Financial Accounting Standards Board (FASB) Statement No. 90 (Accounting for Abandonment and Disallowance of Plant Costs), TVA would have already dealt with the \$5 billion in deferred and currently useless assets. Thus, once again, TVA's financial competitiveness is founded upon practices that would not be acceptable for any of its potential competitors.

Power Rates, Taxes, and Anti-Trust Laws

Let me focus briefly on three other important advantages that TVA wants to retain. First, TVA's desire to retain control over its power rates. Second, TVA's ability to make only token payments in lieu of taxes. Third, TVA's ability to escape penalties if it runs afoul of anti-trust laws.

Let's start with the rates paid by TVA's customers and those paid by the customers of other utilities. In defending its position that it should retain its ability to set its own rates, TVA maintains that it is a low-cost utility and that subjecting it to regulation by the Federal Energy Regulatory Commission (FERC) would force its rates up. But, let's consider the rate picture in Kentucky. Currently, TVA's rate to its wholesale distributors is \$47.0/MWH. In contrast, the wholesale full requirements rate my company charges to our municipal customers is \$29.4/MWH. In fact, by the year 2003, our wholesale full requirement municipal rate will be \$29.1/MWH while TVA's will remain unchanged at \$47.0/MWH.

If TVA is to be allowed to compete outside the fence, then Congress should ensure that it is required to follow the same rate regulations that all shareholder-owned utilities are required to follow. This not only would include wholesale power rates, but also open access transmission tariffs at FERC as are all shareholder-owned utilities. The purpose of those tariffs is to guarantee that any power market participant can gain non-discriminatory access easily and quickly to transmission services from jurisdictional utilities. Currently, TVA is not required to make such filings because the Commission does not regulate them.

Although FERC has attempted to impose reciprocity requirements on TVA, if a power seller seeks to move power across TVA, TVA's compliance is frequently obtained only by the seller requesting an order from FERC, which can slow a transaction by months, or even eliminate it. TVA's voluntary transmission "guidelines," for example, are, for the most part, "window dressing" which appear to be intended as much to persuade policymakers and the public that TVA will play by the same competitive rules that other utilities must obey, as to provide transmission access.

In addition to not being subject to FERC rate rules, TVA avoids payments to FERC and the costs of securing FERC licenses for its hydroelectric projects. Shareholder-owned utilities, on the other hand, pay FERC millions of dollars for the privilege of being regulated. In addition, shareholder-owned utilities spend millions of dollars—not to mention upwards of 7 years of regulatory proceedings—to obtain FERC licenses for hydro projects.

Second, let us turn to taxes. TVA claims that it has no subsidy there because it has no income (so it would not have to pay income taxes anyway) and that it makes "payments in lieu" of taxes to local and State governments. However, with all respect to TVA, they miss the point. TVA's "payments in lieu" of taxes do not even begin to reach the amounts of taxes paid each year by shareholder-owned utilities.

The best way to consider this is on an "apples to apples" basis, total tax obligation as a percentage of total revenue. In 1998, TVA's total payment in lieu of tax obligation was 3.9 percent of its total revenue. In 1998, Kentucky Utilities' total tax payments accounted for 8.1 percent of total revenue. This disparity between TVA's payments in lieu of taxes and the tax burdens of investor-owned utilities is should be closely reviewed not only by this Congress, but by State and local authorities as well.

TVA Must Play By Same Rules As Its Potential Competitors

Finally, another key area that Congress must deal with is anti-trust laws. I cannot emphasize strongly enough that if TVA is not subject to basic rules that govern all other competitors, that exemption, coupled with its total discretion in rate-making, give TVA the power to "control the market" by engaging in predatory pricing or other anti-competitive activities.

TVA is clearly engaged in a commercial enterprise, the supply of electric power. There is no doubt that the activities of private sector companies in the commercial business of supplying electric power are subject to antitrust laws. This means that power suppliers, including members of TVA Watch, all are subject to lawsuits by private parties and by the government for violations of antitrust laws such as the Sherman Act, the Clayton Act and the Federal Trade Commission Act. For example, if a public utility were to supply power to somebody on the condition that the cus-

tomers agree not to compete with that utility, the Department of Justice would probably file an antitrust lawsuit against that utility seeking treble damages and other penalties.

TVA insists the reason it should be allowed to compete either inside or outside the fence under a separate set of rules is that it lacks the “motivation” to engage in anti-competitive behavior because it is a “not-for-profit” agency. However, TVA Watch offers another reason for TVA’s position: We believe the real reason TVA seeks to compete under a relaxed set of rules is because of its financial weakness. In other words, TVA very likely believes it could not succeed in a competitive market unless its financial weakness is compensated by a relaxed set of rules.

In response to calls that it be made subject to the antitrust laws and to treble damages for violations of those laws, TVA offers two general responses, both of which are inadequate. First, TVA claims that it is incapable of competing on an unfair basis because it was created solely to promote “governmental” and “public” purposes. Second, TVA claims that the antitrust laws are directed to eliminating the concentration of economic power in the hands of those who serve only their own profit-making interests, and because TVA is not operated on a “for profit” basis, it should remain exempt from the antitrust laws. Both of these arguments are easily dismissed.

TVA’s power program—its sale and transmission of power at retail and at wholesale—is a commercial enterprise. What this means is that TVA, in reality, is in the commercial business of selling electricity. Moreover, the absence of a “profit motive” is hardly grounds for immunity from antitrust laws. The antitrust laws contain no such “non-profit” exemption and the instinct of a drowning enterprise to survive gives it a more intense motive to suppress competition.

The Supreme Court has also recognized that the instinct of government to survive and thrive in a competitive environmental can lead to anti-competitive behavior. In the landmark case of *City of Lafayette v. Louisiana Power & Light Co.*, 435 U.S. 389, 408 (1978), the Supreme Court noted that public corporations, such as TVA, are fully capable of competitive mischief:

“ . . . the economic choices made by public corporations in the conduct of their business affairs, designed as they are to assure maximum benefits for the community constituency, are not inherently more likely to comport with the broader interests of national economic well-being than are those of private corporations acting in furtherance of the interests of the organization and its shareholders. . . . When (government) acts as owners and providers of services, they are fully capable of aggrandizing other economic units with which they interrelate, with the potential of serious distortion of the rational and efficient allocation of resources, and the efficiency of free markets which the regime of competition embodied in the antitrust laws is thought to engender.”

TVA’s position that it can compete fairly under only certain antitrust laws simply does not serve the public interest because there will be no deterrent. If the remedy at the end of the proceeding is a slap on the hand, then no rational person would ever initiate the process. There must be a deterrent to keep TVA from committing anti-competitive acts in the first place. That deterrent can only come in the form of making TVA pay damages for the competitive injuries that result from violations of the antitrust laws. If TVA claims that it, a billion dollar commercial enterprise, can’t afford to pay antitrust damages, we have one simple response: If you can’t do the time, don’t do the crime.

Conclusion

TVA Watch encourages this Committee, and indeed all of Congress, to consider carefully the ramifications on TVA’s original mission, and the significant effects on the nation’s debt and taxpayer’s pockets, of enacting legislation allowing such competition from a taxpayer-supported Federal utility.

TVA Watch supports efficient competition that is not skewed by allowing TVA to escape legal or regulatory burdens shareholder-owned utilities must bear. This disparate treatment distorts competition.

We at TVA Watch are committed to working not only with this Committee, but with all others who are genuinely interested in reforming TVA. The plain language of the TVA Bond Act remains and its purpose has not been lost. TVA Watch hopes that this Committee, and Congress as a whole, will assure that the objective of encouraging more competition in America’s electric power industry will be supported by making the right decisions about the future of TVA.

RESPONSES OF ROBERT HEWETT TO ADDITIONAL QUESTIONS FROM SENATOR
MCCONNELL

Question 1. TVA has said that FERC oversight would impose a cost burden which may require them to raise their rates. Does your experience support that statement?

Response. No. The cost of FERC regulation is not material in relation to the scope of a utility's business. My company is considerably smaller than TVA and does not raise its rates as a result of the costs of FERC regulation. In fact, FERC regulation would provide an economic costing discipline that would benefit customers in the decisionmaking process on capital expansion and expense control.

Question 2. Mr. Hewett, TVA argues that it can't be FERC regulated and be able to appease Wall Street. How is it that LG&E Energy is able to accomplish this (walk and chew gum at the same time), while maintaining some of the lowest rates in the nation?

Response. We have found that FERC regulation is a key source of discipline in measuring the soundness of our balance sheet. Other sources of discipline include competition, State regulation, debt ratings and, of course, the price of our stock. The extent to which our company is able to measure up to the standards set by these various disciplines is directly related to the confidence expressed in our performance by Wall Street.

Question 3. Mr. Hewett, how does FERC regulation impact your decisionmaking in setting a course for your company, and has FERC regulation inhibited your ability to adequately serve your customers?

Response. As a result of FERC regulation we must provide non-discriminatory open access to our transmission system and must charge our wholesale requirements customers just and reasonable rates. These regulatory requirements affect how we make business decisions. Such requirements reflect FERC's implementation of the Congress' public policy decision to limit regulated utilities' ability to leverage essential facilities and market position at the expense of consumers. We accept these as legitimate constraints on our business. Such constraints, however, do not limit our ability to serve our customers. Indeed, we have found that, in addition to normal rate proceedings, FERC provides useful data that enables us to monitor the activities of other utilities and market-related developments. In addition, FERC requires utilities under its jurisdiction to operate under a consistent set of requirements which accomplishes customer pricing benefits.

Question 4. Mr. Hewett, have you been able to meet your customers' demand during the peak demand periods of the past two summers? Will you be able to meet the rising demands of the region in the foreseeable future? What role does FERC play in this planning?

Response. While events of the past two summers presented our system with significant challenges, we were able to meet the needs of our customers. We attribute this success to two factors. First, the employees of our company performed their functions in an exemplary fashion. Second, we were able to work with our neighboring utilities, including TVA, to ensure that all of us had access to other supplies of electricity on the spot market. We expect to meet the rising demands of our customers. FERC plays a useful role by making available data that we utilize in formulating our business plans. Additionally, it is noteworthy that, as a general matter, FERC's open access transmission policies increase the efficiency of the electric power market in its ability to meet peak demands and our ability to access the market for purposes of purchasing peaking options and, if necessary, energy on the hourly market.

Question 5. LG&E Energy Corp., which owns KU, made an announcement earlier this year that they will reduce electricity bills by \$52 million over 5 years. This was excellent news for LG&E and KU customers. How do you explain why TVA's rates are higher and going higher, while the rates of your company and other utilities in Kentucky are lower and headed lower?

Response. We believe a key reason for this disparity is the level of long-term debt between TVA and other utilities. TVA's long-term debt of nearly \$27 billion is more than four times the level of a comparably sized utility. Moreover, nearly \$8 billion of TVA's long-term debt is not currently being recovered in rates. In contrast, LO&E, which is roughly one-quarter the size of TVA, has a long-term debt of approximately \$1.6 billion. As I mentioned in my written testimony, the General Accounting Office (GAO) has said that as competition evolves in the electric power industry, TVA's flexibility to respond to market signals will be impaired if it does not successfully implement its goal of cutting its long-term debt in half by 2007.

Question 6. On average, how many cents of every dollar in KU rates go toward paying interest charges?

Response. Approximately four cents.

Question 7. Please discuss how you see the TVA Customer Protection Act benefiting TVA customers.

Response. We believe the most important elements of Senator McConnell's bill are (1) requiring TVA to comply with the same anti-trust laws and wholesale price and transmission regulations that govern other utilities and (2) imposing limits on TVA's construction of new generation facilities without the expressed agreement of its customers that they will bear the costs of such facilities. TVA Watch believes it is imperative that as the electric power industry evolves to a more competitive structure TVA plays by the same rules as other utilities. TVA's customers will benefit because they will enjoy that same competitive opportunities as other utilities' customers and will enjoy the same protections from discrimination and the exercise of market power that are available to others' customers.

STATEMENT OF RICHARD MUNSON, EXECUTIVE DIRECTOR, NORTHEAST-MIDWEST INSTITUTE

Testimony on the Tennessee Valley Authority

The Tennessee Valley Authority is a political creation facing its most serious challenge. The nation's largest electric utility suffers an enormous debt, mismanagement, and falling political support at the very time that lawmakers are restructuring the nation's electric utility industry and transforming the way consumers buy electricity. Sixty-five years after it was created, this giant Federal agency can no longer justify its existence.

TVA has accumulated a whopping \$28 billion debt, largely because of its inaccurate predictions of future electricity demand, its failure to control the costs of constructing nuclear power plants, and its unwillingness to impose rate increases in order to meet those costs. Other signs of mismanagement were revealed in a recent report from TVA's own Inspector General (IG), who criticized the agency's six-figure bonuses and secret retirement funds for top executives, non-competitive consulting contracts to cronies of those officials, and expensive building leases with well-connected developers.

The IG's report highlights perhaps TVA's most serious problem its unaccountability. This Federal institution is run by a board of three individuals appointed to staggered nine-year terms by the president, often as a favor to political supporters from the region. Board members are not answerable to the voters. Their decisions are not reviewed by State regulators or Federal agencies, and until recently, Congress provided little oversight. TVA also enjoys a monopoly in its service territory, so it's not accountable even to market forces.

TVA has been propped up by enormous taxpayer subsidies which can no longer be justified or countenanced. The giant utility is exempt from hundreds of Federal and State laws and regulations, it pays no Federal or State taxes, and it obtains low-cost loans because of Washington's "implied" support.

There's little doubt that TVA has become a burden to the nation's taxpayers. What's becoming increasingly apparent is that the status quo also harms the very Tennessee Valley residents that TVA is supposed to serve. Some of the region's politicians, of course, continue to defend the agency and its subsidies, but TVA's functions could be provided more effectively and less expensively by other corporations or agencies.

Subsidies

TVA officials often repeat a mantra about their power operations being supported solely by electricity sales, but in this era when subsidies are suspect the giant utility remains the beneficiary of enormous taxpayer largess. It pays no taxes, enjoys access to low-cost capital, and avoids scores of Federal laws and State regulations.

According to the study by Putnum, Hayes & Bartlett, a respected consulting firm hired by investor-owned utilities, TVA's tax and cost-of-capital subsidies in 1993 totaled a whopping \$1.2 billion. Included in that figure, TVA avoids more than \$570 million annually in Federal and State income taxes that would be paid by a comparable-sized private utility. It also escapes more than \$450 million annually in State and local ad valorem and other taxes. TVA counters that it contributes more than its share of local taxes through its 5-percent "payments in lieu of taxes," but shareholder-owned utilities pay State and local taxes that amount to 8.3 percent of operating revenues, plus Federal taxes that equal 4 percent of operating revenues. In short, for every dollar of revenue collected, TVA pays only 5 cents while investor-owned utilities pay some 12.3 cents in taxes.

Other benefits are substantial but not quantifiable. Unlike other power companies, for instance, TVA avoids ratemaking oversight by the Federal Energy Regu-

latory Commission and State public utility commissions. It is free from the financial oversight of the Securities and Exchange Commission. It is exempt from Federal and State antitrust laws. It doesn't have to worry about strikes by its employees. It benefits from government purchasing programs. It doesn't have to comply with numerous environmental regulations.

TVA is literally above the law. It is exempt from at least 137 Federal statutes, ranging from workplace safety and hydroelectric licensing. It is immune from civil liability for its wrongful acts, yet it enjoys far-reaching Federal eminent domain authority. TVA also claims immunity from an array of State legislation and regulations, including at least 165 in Alabama alone.

TVA's bond rating is a particularly odd but very generous benefit. Despite having a massive debt of some \$28 billion, TVA enjoys a AAA bond rating, the highest available. No shareholder-owned utility, despite much better balance sheets, has such a rating. Even though Federal legislation specifically declares that taxpayers do not guarantee TVA bonds, the rating agencies assume such backing is implied. According to Moody's Investors Service, "Although TVA's debt is not an obligation of the U.S. government, the company's status as an agency and the fact that the government explicitly is TVA's only shareholder, indicates strong 'implied support' (that) would afford assistance in times of difficulty. This implied support provides important bondholder protection. TVA's extensive nuclear risk, average competitive position, and high level of debt would make it unlikely to maintain its current (AAA) status." TVA's chairman, in fact, promotes the agency's bonds as having "an obvious, implied" guarantee from the Federal Government. (It should be noted that if the government did guarantee TVA bonds, taxpayers would be left holding the bag if the agency defaulted on any portion of its multi-billion-dollar debt.) Several analysts suggest that TVA's large debt and low cash flow should cause its bonds to be rated as junk. TVA's artificially high credit rating, therefore, allows the giant utility to issue large levels of debt at low cost. According to the Department of Energy, if TVA were to lose its AAA rating, its annual interest cost could increase by some \$270 million. This indirect Federal subsidy would be even higher if TVA bonds were rated as junk, or below investment grade.

TVA officials like to suggest that the utility can compete in a deregulated electricity market. But the more important question is whether TVA, armed with its subsidies and other competitive advantages, should be allowed to compete.

Environmental Steward or Threat?

One of TVA's original missions was to manage the region's natural resources, but the agency long has invoked the ire of environmentalists. TVA, for instance, was the leading promoter of destructive coal strip-mining, ruining vast tracts of land and debilitating Appalachia's underground coal industry. Its reclamation efforts were minimal and only marginally effective. Aubrey Wagner, who directed the agency for almost two and one-half decades, voiced an attitude that sent chills up the spines of conservationists: "but. . . if yo looke at what these mountains were doing before this stripping, they were just growing trees that were not even being harvested."

TVA remains one of the nation's worst violators of the Clean Air Act. The agency, in fact, is the largest emitter among eastern utilities of nitrogen oxide (NOx), which causes smog. It is the third largest emitter of sulfur dioxide (SO₂) and carbon dioxide (CO₂), which has been identified as the leading cause of global warming.

TVA's nuclear program has been so plagued with safety and economic problems that consumer activist Ralph Nader in 1998 declared: "The TVA is by any measure the worst nuclear project in the country, has the most expensive set of nuclear reactors, has a debt of \$29 billion, has the poorest safety record with TVA reactors spending more time on the Nuclear Regulatory Commission's watch list than any other utility."

Like many private utilities, TVA from the mid 1960's through the mid 1980's continually overestimated the future demand for electricity. Unlike most other companies, however, TVA went whole hog for nuclear power to meet that projected demand. The agency in the mid 1970's announced plans to build 17 reactors at seven sites. It completed only six, and one of those was shut down in 1985.

Rather than promote energy efficiency, TVA has used promotional campaigns and subsidized rates to encourage its consumers to be wasteful guzzlers. The average Tennessee resident uses more electricity than consumers in any other State, more than 50 percent above the national average. The other six States partially electrified by TVA also rank among the most energy intensive. Decrying TVA's early promotion of electric heating rather than less-expensive, more-efficient, and less-polluting natural gas, former TVA Director David Freeman observed that TVA customers were "snookered into using so much electricity." If a Tennessee homeowner in the 1950's had installed a natural gas furnace instead of an electric heater, he or she would

have saved more than \$300 each year in energy bills. TVA, at the same time, would have avoided the need to build expensive and polluting power plants.

Bonuses and Questionable Contracts

TVA's senior officials seem to treat themselves and their colleagues well. So well, in fact, the TVA's Inspector General in early 1998 lambasted agency operations, including secret retirement accounts, six-figure bonuses, and non-competitive consulting contracts. Perhaps the best description of the charges comes from an editorial by the Chattanooga Times, a key Valley newspaper that usually defends TVA. "One of the most egregious abuses is in the area of compensation," commented the paper. "TVA secretly established a Senior Executive Retirement Plan (SERP) in 1996 and funneled almost \$5 million in previously undisclosed contributions through it to 24 high-ranking managers over the past 2 years. Neither the agency's Inspector General, nor congressional leaders, nor the general public, knew about the SERP until the IG discovered it last month."

The Inspector General also attacked TVA's end-of-the-year bonuses to key managers. According to Electricity Daily, "The Tennessee Valley Authority sweetened the holidays for some of its top executives, but the agency's decision to award six-figure bonuses has soured a Tennessee congressman. Rep. John Duncan Jr. (D-TN) said . . . he was disgusted that TVA paid out \$1.9 million to 84 of its top executives in year-end bonuses. The Knoxville congressman said he believed the agency was using the bonuses to dodge a salary cap imposed by Congress."

The generous consulting contracts also were lambasted by the Inspector General. Again in the words of the Chattanooga Times: "TVA's free-flowing millions on consulting contracts (631 consulting and training contracts with 350 different vendors totaling \$145.1 million, with an average of \$29 million per year over 5 years) are equally disturbing. Excessively generous contracts are given to cronies or friends of top managers without bids or acceptable oversight. The practice suggests responsible fiscal management is not being applied and undermines TVA's integrity and its pending request for Federal appropriations."

Playing Hard Ball

While TVA is quite generous to its managers and their friends, it maintains a rather domineering relationship with its own customers. TVA consumers, in fact, are burdened with long-term, all-requirements contracts which they can terminate only by providing a ten-year notice. These are not ten-year contracts that expire; they are rolling provisions that after each new day cannot be terminated for another 10 years. The municipal utilities and rural electric cooperatives that buy power from TVA, as a result, are restricted from the benefits of competition; they cannot even obtain realistic price quotations for power to be supplied in 10 years. The Federal Energy Regulatory Commission does not allow private utilities to use similar anti-competitive provisions.

The 4-County Electric Power Association, wanting lower rates, notified TVA in December 1993 that it would be seeking another power supplier. Earl Weeks, the Mississippi association's general manager, subsequently received some 30 bids from other electric generators, several of which would have saved the association more than \$7 million annually in wholesale power costs. TVA, unwilling to lose a customer, responded aggressively. According to Weeks, TVA lobbied 4-County's biggest customers "to put pressure on us to rescind that notice." More troubling to the association manager, TVA representatives "questioned my integrity" by suggesting to customers that perhaps Earl Weeks didn't know what he was doing. But TVA's most effective tactic was to threaten cancellation of a lignite-burning power plant and elimination of the associated construction jobs and economic development in that employment-hungry region. Not surprisingly, 4-County Electric buckled under the pressure.

The Bristol Utility Board in southwest Virginia met similar resistance when it notified TVA that it, too, wanted to leave. Angry about high industrial electricity rates, the municipal utility gave TVA "years of forewarning" that it wanted to end its 52-year relationship and to seek bids from other suppliers. TVA's price offer turned out to be the very highest of 20 bids. Therefore, Bristol in 1997 signed a contract to purchase electricity for its 15,000 residents from Cinergy of Cincinnati, Ohio, saving the local government \$70 million over 7 years, double the city's annual budget. TVA responded by secretly trying to sell power directly to Bristol's industrial customers for 2 percent less than the best bid (and well below what TVA had previously been charging, and well below the agency's recent bid). TVA also promptly charged Bristol \$54 million for "stranded costs" investments the Federal agency claimed it made with the expectation that it would continue to supply power to Bristol. Rep. Rick Boucher (D-VA), the local congressman, reacted with angry letters and volatile hear-

ings. He complained that TVA was using tactics "to punish a former customer for exercising its legal right to obtain power from a less expensive supplier. TVA is seeking to make an example of the city of Bristol so as to discourage any other community presently served by TVA from considering the purchase of power from a TVA competitor." After a Boucher-inspired hearing before the House Judiciary Committee, at which die-hard liberals such as Reps. Barney Frank (D-MA) and John Conyers (D-MI) asserted that TVA's arrogant ways and monopolistic practices would make "FDR turn over in his grave," and after it appeared that the Federal Energy Regulatory Commission would not allow the agency to recover these costs, TVA backed down, announcing that it would no longer seek stranded cost recovery from Bristol.

TVA's other customers took hope from Bristol's victory. Representatives of the "Big Five" (municipal utilities in Nashville, Chattanooga, Huntsville, Memphis, and Knoxville), which constitute 30 percent of TVA's market, began meeting to discuss strategies. Larry Fleming, general manager of the Knoxville Utilities Board, which is about ten times larger than Bristol, said other distributors want a deregulated industry in which they can purchase less expensive power in a competitive market without having to pay TVA for "stranded investment costs."

The Valley's municipal utilities and rural cooperatives are making progress, albeit slowly. TVA recently said these distributors can avoid paying stranded costs if they sign new ten-year service contracts that include a five-year cancellation notice (reducing by 5 years the current notice requirement).

Yet TVA is not welcoming competition. It defends vehemently its right to restrict other power suppliers from moving or "wheeling" electricity over TVA's grid to customers inside the fence. That effectively leaves Valley residents with just one option: Pay what TVA charges or go dark.

Facing Economic Realities?

To accumulate a \$28 billion debt while enjoying monopolistic control over its service territory must rank among the most egregious examples of business mismanagement. During the many years when the agency's debt skyrocketed, politically-motivated officials refused to raise revenue by increasing electric rates. In fact, they boasted that rates had not risen for a full decade. Yet in July 1997, TVA officials could no longer avoid reality they increased rates by 5.5 percent and announced an ambitious ten-year plan to cut the agency's debt in half (from \$28 billion to \$14 billion by 2007) and subsequently to reduce its prices by 16 percent (from 4.11 cents per kilowatt-hour to 3.5 cents by 2007).

The much-needed proposal demonstrates a new commitment to get TVA's financial house in order. Unfortunately, the plan, according to the General Accounting Office, is based on "unreasonable assumptions." For instance, for TVA to argue that it will reduce its capital expenditures from \$732 million in 1997 to \$500 million in 2000 it must exclude the \$1 to \$3 billion it must spend to meet clean air requirements. TVA also fails to account for replacing or upgrading its aging coal, nuclear, and hydro units, and it assumes that it need not build any new generators to meet its own projected increased demand for electricity.

TVA, moreover, does not specify how it will achieve \$2 billion in cost cuts. Although the electricity market throughout the country is becoming competitive and most utility restructuring bills before Congress eliminate electric monopolies, TVA assumes that it will retain monopoly control of its customers. Although TVA's total operating revenues since 1989 have declined more than 10 percent in real terms even while kilowatt-hour sales increased by about 35 percent, TVA unrealistically assumes that a rate increase in 1997 will result in increased revenues of \$345 million in 1998, or more than 6 percent on average. And although TVA's operating expenses have increased in recent years, the agency projects that its operating expenses (less depreciation) will decline over the next four to 5 years and rise only by small amounts thereafter.

Moreover, TVA assumes that the energy market will not change, that it will maintain monopoly control over its distributors, despite the billion-dollar-deals and aggressive competition engendered by new State restructuring programs. Consider just the potential competition from privately-owned generators fired by natural gas. Although pipelines have tended to avoid the Tennessee Valley, in part because of TVA's dominance, three natural gas firms showed up recently to compete for new markets in Clairborn County, Tennessee. Since innovative natural-gas-fired turbines can generate electricity cheaper than can TVA, industrial customers within the Valley may soon be able to generate their own less-expensive power. New microturbines are making this option available even for commercial firms like a McDonald's restaurant, and engineers envision refrigerator-sized turbines supplying individual homes with electricity and heat. As new pipelines offer natural gas throughout the

Valley, independent power producers also will soon compete for markets with TVA, throwing the giant utility's growth projections into serious question.

Restructuring, Reform, and Privatization

A growing number of States have restructured their utility industry, replacing monopolies with competition. Federal lawmakers are advancing similar proposals, and TVA, just like every smaller utility throughout the nation, faces change.

TVA bureaucrats may like the status quo, but the current monopoly structure complete with its arrogance, unaccountability, and mismanagement simply is too expensive for both the nation's taxpayers and the Valley's ratepayers. Senator Mitch McConnell (R-KY), a senior senator from within the Tennessee Valley, introduced legislation in April 1998 to make TVA accountable to its customers. The Tennessee Valley Customer Protection Act, according to McConnell, "will require TVA to justify its rates." To have TVA play in a competitive marketplace without unfair advantages, McConnell proposes to have agency become a "public utility" subject to the authority of the Federal Energy Regulatory Commission. He would force TVA to disclose publicly its tariffs and schedules, to abide by antitrust laws, and to restrain from competing against private-sector businesses for equipment leasing and engineering services.

McConnell's reforms move significantly toward accountability and fairness. Other possible steps include the removal of TVA's exemption from nuclear decommissioning rules, a requirement that TVA abide by all relevant environmental laws and regulations, and an equalization of labor laws and civil liability laws among all power suppliers.

Noting the increased calls for reform, even TVA officials have begun to admit that some changes are probably needed, but their proposed "reforms" are rather cute . . . and suspect. Noting criticism that it alone in the utility industry doesn't face oversight by the Federal Energy Regulatory Commission, TVA recently offered to follow FERC rules voluntarily. But such a move differs substantially from submitting to the same rigors of regulation as the rest of electricity industry. TVA's proposal, for instance, would exempt it from paying penalties for failing to comply with FERC regulation.

Noting criticism that it alone avoids antitrust oversight, the government-owned monopoly also recently offered to allow courts to review its actions. But TVA cleverly notes that it would not subject itself to the same level of enforcement and penalties as others in the power industry. TVA may not want treble damages, but the threat of such penalties influences behavior and is needed as a check on all unfair competitors.

The most direct reform, of course, would be privatization getting the Federal Government out of the electricity business. At least two dozen other countries over the past decade have launched electricity privatization programs, including highly developed countries such as Australia and Britain, as well as emerging economies such as Argentina and Taiwan, as well as former communist countries such as Hungary and Poland. This global move from government control to the free market is described well in Daniel Yergin's recent *The Commanding Heights*. Senator Frank Murkowski (R-AK), who knows first hand about the privatization of the Alaska Power Administration, stated the issue succinctly: "When the rest of the world is trying to get government out of business, so should we."

The privatization debate offers some fascinating rhetorical inconsistencies. Some TVA beneficiaries argue vehemently that the government should get out of business and let the free enterprise system work its wonders. Although they wouldn't fathom having the Air Force compete with Delta Air Lines, some maintain that Washington should continue to own and control the nation's largest utility.

Is there some failure in the electricity market that requires government intervention? There was 70 years ago when only 15 percent of rural Americans enjoyed electricity. But strong private-sector electricity companies exist throughout this country. One could argue that there's far more justification for the Air Force to provide rural airplane service than there is for the Federal Government to generate electricity.

A long list of suitors—power brokers, independent power producers, shareholder-owned utilities, and investment bankers—have expressed an interest in TVA assets, assuming the agency reduces its enormous debt. Peter Lynch, the famous former manager of the giant Fidelity Magellan mutual fund, stated, "There has never been a serious effort to privatize the TVA but if there was I would be the first in line to get a copy of the prospectus."

Privatization advocates have even come from within the agency. William Malec, who retired in 1995 as TVA's executive vice president and chief financial officer, argued that selling the "New Deal dinosaur" could reduce the Federal deficit and add \$600 million a year in taxes to the Federal till. Privatization, said Malec, "would

move one of the largest electric companies in America out from under the burden of Federal bureaucracy into the private sector, where I believe it could compete effectively, without excuses or alibis." Noting that a sale would generate big savings for the U.S. taxpayer, Malec called TVA's hydropower and coal-fired plants "dramatically undervalued" and added: "If TVA's physical generating capacity were valued at only half of what it would cost to replace it, TVA's net asset value would be \$50 billion, rather than its current book value of \$32 billion."

Options for selling TVA's assets are numerous and varied, according to *Should the Federal Government Sell Electricity*, a November 1997 study by the Congressional Budget Office (CBO). The British privatized their electric utilities and other industries, selling common stock in the enterprises to the general public. The U.S. government already has sold numerous assets, including the Alaska Power Administration, Conrail, the U.S. Enrichment Corporation, the naval petroleum reserve at Elk Hills, and radio spectrum rights. According to CBO, "There are strong similarities between the sale of spectrum licenses and power facilities: many different combinations of asset types and locations may be offered, each having a different value for different buyers."

Federal restructuring legislation must address TVA, if for no other reason than TVA is the nation's largest utility. The government simply must get its own house (or businesses) to participate fairly in a competitive electricity market as it orders others to do the same. Any such legislation must recognize that in this era when hundreds of private-sector firms want to generate and sell electricity, the Federal Government should no longer do so. It's time for politicians to declare victoriously that TVA served its purpose. Yet since situations have changed in the past 65 years since TVA was created, it's also time for politicians to restructure this outmoded government agency that has become too expensive for both taxpayers and ratepayers.

NORTHEAST MIDWEST INSTITUTE,
Washington, DC 20003, October 14, 1999

The HONORABLE JOHN H. CHAFEE,
Committee on Environment and Public Works,
U.S. Senate,
Washington, D.C. 20510.

RE: TENNESSEE VALLEY AUTHORITY

Dear Mr. Chairman: Your 7 October letter did not include questions submitted by Senator Mitch McConnell, and subsequent conversations with his staff suggest that the Senator's questions were not directed to me. However, I'd like to add two thoughts to the hearing record, responding to points advanced at the hearing.

First, Senator Fred Thompson complained that Congress had eliminated appropriations for TVA's non-power programs. It needs to be made clear that the original suggestion for such action came from TVA's own chairman. It also needs to be stated that the \$1.2 billion subsidy provided to TVA in last year's omnibus appropriation cannot be viewed as compensation for the relatively small \$50 million that might be appropriated for non-power operations.

Second, Mark Medford stated that TVA had no interest in selling power outside of the Tennessee Valley. I would caution the committee about TVA's history of shifting its positions. Just a year ago, TVA's chairman was suggesting that the agency would become "America's power company," providing electricity (subsidized by taxpayers, I should note) throughout the nation.

Thank you for the opportunity to testify before your committee about needed reforms for the Tennessee Valley Authority.

Sincerely,

DICK MUNSON, *Executive Director.*

STATEMENT OF MARK MEDFORD, EXECUTIVE VICE PRESIDENT, CUSTOMER SERVICE
AND MARKETING, TENNESSEE VALLEY AUTHORITY

Introduction

Mr. Chairman, I want to thank you for this opportunity to update the Committee on a variety of issues relating to TVA's ongoing activities and electric industry restructuring, including S. 1323, which is entitled the "TVA Customer Protection Act of 1999." My name is Mark Medford and I serve as TVA's Executive Vice President for Customer Service and Marketing. My responsibilities include working with the 159 distributors of TVA electric power and 68 direct-served customers within the

Tennessee Valley who would be most directly affected by restructuring legislation. I also have been designated as the lead TVA executive on electricity restructuring matters.

I applaud this committee's interest in the issues surrounding TVA's role in the evolving electricity industry. As you well know, other committees in both the House and Senate have been contemplating the intricate issues surrounding industry restructuring at both the State and Federal level. TVA has been actively involved in these efforts and, at the risk of stating the obvious, sorting out this legislative effort is not an easy task.

I also appreciate your care in seeking assurance that new laws and regulations pertaining to TVA will not impair TVA's ability to serve the needs of the Tennessee Valley in the restructured industry of the future.

I look forward to responding to the questions this subcommittee may have as you address how TVA fits into this debate.

Background on TVA

The Tennessee Valley Authority is large and complex. TVA is a Federal corporation, the nation's largest public power producer, a regional economic development agency, and the steward of the Tennessee River basin. TVA was established by Congress in 1933, primarily to provide flood control, navigation, and electric power in the Tennessee Valley's seven State region. The TVA Act also directs its three-member Board of Directors to set the lowest feasible electric rates for the Valley. TVA is a recognized leader in the Tennessee Valley, certainly for providing low-cost electricity, but also for our economic development initiatives, and our integrated resource management.

The Tennessee River is the fifth largest river system in the United States. It stretches 652 miles from Knoxville, Tennessee to Paducah, Kentucky. It encompasses 11,000 miles of shoreline, more than 50 dams and a dozen locks. About 34,000 loaded barges travel the Tennessee River each year—the equivalent of two million trucks traveling the roads. Before TVA, the Tennessee River flooded regularly, causing millions of dollars of damage whenever it left its banks. Under TVA's integrated resource management the Tennessee River is the only major river system in the United States that has not suffered widespread flooding in over 60 years.

TVA's power system has a dependable generating capacity of 28,417 megawatts. TVA's generation consists of approximately 61 percent coal, 28 percent nuclear, and 11 percent hydropower. TVA provides wholesale power to its 159 local municipal and cooperative power distributors through a network of 17,000 miles of transmission lines in the seven State region. TVA also sells power directly to 63 large industrial and Federal customers. Ultimately, TVA supplies the energy needs of nearly eight million people every day over a power service area covering 80,000 square miles, including Tennessee, and parts of Mississippi, Alabama, Georgia, North Carolina, Virginia, and Kentucky.

TVA's service area is now limited by law. A "fence" keeps TVA from serving customers outside its region as defined under a 1959 law. Under the 1992 Energy Policy Act, electricity companies are prohibited from "cherry-picking" customers inside the TVA region, the most attractive of which have large, concentrated loads.

TVA's Recent Efforts to Improve

Over the past 5 years TVA has worked very hard to improve all aspects of its operations. Two years ago, TVA adopted a Ten-Year Business Plan specifically designed to ensure that TVA will be comparable with the evolving electricity industry of the future. The Ten-Year Plan was not developed as a plan to avoid financial failure. On the contrary, TVA is more financially sound today than it has been in many years. We have reversed a pattern of increasing debt that was unbroken for 35 years and have now been on a path of debt reduction for three consecutive years; reducing our total debt by well over \$1 billion. We have maintained adequate power supply and transmission capacity to ensure reliable electricity delivery, even during the challenging summers of 1998 and 1999. At the same time, we have reduced our workforce from more than 30,000 10 years ago to little more than 13,000 today. We have established an \$800 million fund to fully provide for the future decommissioning of our nuclear plants; we sponsor this country's 110th largest pension plan holding assets well in excess of liabilities. We have done all of this, I might add, with only one modest price increase in the last 12 years and with the refinancing of the Federal Financing Bank debt.

The overriding goal of the Ten-Year Plan was simply to keep TVA's total delivered cost of power at a level consistent with the forecast of the future market price of power in the Southeastern United States. I point out this competitive price goal to distinguish it from the several operating and financial strategies we committed to

pursue in order to meet that goal. Among these operating strategies were reducing the labor and material components of our cost and increasing the utilization of our facilities. TVA committed to take all of the cash generated or released by these operating strategies and use that cash for debt refinancing and debt reduction, thereby reducing interest expense—one of our largest expense categories.

The Ten-Year Plan is now 2 years old and during that 2 years, changes have occurred—some positive and some negative. One obvious, and positive, change, for example, has to do with interest rates which been substantially lower than the 7 percent estimate of 2 years ago. The continued strength of the U.S. economy, coupled with several refinancing strategies TVA pursued, means our average interest rate will be lower than expected.

But let me focus on two more complex assumption changes that have occurred in the past 2 years.

The first is in the area of spending for environmental compliance. TVA is committed to environmental leadership. With regard to Clean Air, last summer TVA announced that it would commit to early compliance with regard to NOx reductions—at a cost of approximately \$500 million. In addition, TVA was one of the first and largest participants in the Climate Challenge. However, TVA must also strive to balance its environmental leadership commitment with its responsibility to ensure a sound financial future. We are following closely developments which would assist in that regard. For example, Mr. Chairman, we have been very interested in developments such as your Credit for Early Action bill (S. 547). Unfortunately, there are significant financial uncertainties associated with the possible outcomes of proposals relating to Clean Air Act compliance and climate change.

Two years ago, we noted in our Ten-Year Plan that we could not foresee the exact timing or magnitude of expenditures that might be required. But, we reassured our stakeholders that such costs, when they occurred, should not render TVA non-competitive, because such costs would be imposed on almost all industry participants to a greater or lesser degree. When that happens, then the market price of power must rise, so that all industry participants can recoup their investments.

The second major change has been in expected needs for power supply in our service territory. Demand is now expected to exceed our 1997 estimate of 2 percent annual growth and perhaps be closer to the near-four percent rate of the past decade. We intend to accommodate this growth without an increase in the levels of overhead and if we do, it will drive our average costs still lower. But we know this growth comes at a price. It will impose higher demand for capital investment for generating capacity, taking money previously earmarked for debt reduction.

But something else is affecting TVA in terms of power supply and that has to do with the availability and reliability of purchased power. All industry participants are now well aware of the risks of relying on purchased power during times of peak power demand. Just this past summer, several power marketing organizations failed to meet power supply contracts. This has forced all utilities to question the reliability of short-term power contracts to meet peak power demands. Some, like TVA, have refused to gamble with reliability and instead have committed to the addition of physical plants to ensure an adequate and reliable source of electricity. While these plants promise to drive down our average cost of power, they will, like the generating facilities discussed above, impose higher demand for capital investment, taking money previously earmarked for debt reduction.

TVA's Future Role

It is an understatement to say policy-makers in Washington and the States have spent a substantial amount of time and effort on the future of the electricity industry. I can assure you that we in the Valley have also dedicated a great deal of time and resources on this important issue. We look forward to continuing to participate in this debate as Congress moves forward.

We are pleased that most of the debate affirms TVA's continued role within the Valley to manage the river system and to be a provider of electricity for Valley residents. In this regard, we want to emphasize that TVA supports the TVA Title in the Administration's Comprehensive Electricity Competition bill, released on April 15 of this year, and greatly appreciates DOE's impressive effort that was undertaken to integrate the interests of a wide variety of stakeholders.

Almost at the same time the Administration was drafting its bill, some Members of Congress from the TVA region urged TVA to sit down with its distributors and work directly with the Tennessee Valley Public Power Association, which represents TVA's 159 distributors, in order to develop a regional solution for inclusion in the restructuring legislation before Congress. I was pleasantly surprised at the number of areas we agreed upon. Of course, there are some outstanding differences, just as one would expect when a seller and his customers sit down to discuss their relation-

ship in an emerging marketplace. In fact, the diversity of the TVA customer base has resulted in some differences even among our customers. Nevertheless, we are committed to continuing our discussions with TVPPA and all stakeholders in the Valley.

Of course, the Administration's bill is not the only proposal on the table. There are many with a variety of provisions. As we move forward, we note with an element of caution that there are some proposals being actively considered that risk compromising the low-cost, reliable electricity available for the people of our region. We believe that some aspects of the TVA Customer Protection Act of 1999 may inadvertently have such effects and it is for that reason that we welcome the opportunity to discuss the potential implications of the bill today.

TVA Customer Protection Act of 1999

First, it is essential that TVA's future role in a restructured electric power industry should be addressed in the context of comprehensive national electric power industry restructuring legislation. To seek to address TVA independently of those national policy decisions presents significant risks of fashioning a future for TVA that is ill-suited for how the regional electric power markets will be operating.

The TVA Customer Protection Act of 1999 is limited in its coverage to only TVA—changing the way TVA provides power within the Valley by placing a number of new restrictions on TVA, as well as by expanding regulation of the activities of TVA.

These proposals are, of themselves, somewhat unusual in the context of a discussion of "deregulation" because they would impose far more outside regulation of a governmental entity like TVA at the same time that the trend is to reduce the regulation of private utilities. In addition, some proposals, such as subjecting TVA to monetary penalties for violations of the antitrust laws, are very unfair to TVA ratepayers and can only unnecessarily drive their power rates up. When a private utility violates the antitrust laws, its stockholders bear that cost. However, governmental entities like TVA have no stockholders, and the financial costs of such penalties have to be borne by the people who are supposed to be served. Other governmental entities are not liable for such monetary penalties under the antitrust laws, and there is no reason why TVA should be singled out to be treated differently.

Our major concerns are those provisions of the bill that would require FERC and State regulation of TVA prices and for FERC's determination of the need for new TVA generation. The fundamental purpose of TVA, as far as power production is concerned, is to deliver power at the lowest feasible cost to the people of the Tennessee Valley. Responsibility for fulfilling that mission is placed on the three member TVA Board, nominated by the President of the United States and confirmed by the Senate. To superimpose a higher regulatory body, FERC, to pass judgment on the decisions of the TVA Board in these areas seems both duplicative and inappropriate.

An examination of the social goal of rate regulation (by FERC or State PUCs) in contrast to the mission of the TVA supports the inappropriateness of the proposal to subject TVA to FERC rate regulation.

When any corporate entity like a private utility, created for the principal purpose of enhancing the wealth of its owners, is granted by a government a legally incontestable right to serve a group of customers, government has historically seen a need to protect those customers from price abuse. It is in this spirit that regulations of private utilities were created—to protect customers from prices that might exceed those charged in a competitive market. Contrast this to the purpose of public power. Public power entities, like TVA, are not created to "enhance the shareholder wealth." Quite the contrary, they are usually mandated (as TVA is in the TVA Act) to provide power at the lowest feasible rate.

Congress wisely foresaw the need to charge the TVA Board with the responsibility to provide for the power needs of the people of the Tennessee Valley. Giving FERC and seven separate States (which might go seven separate directions—thereby undermining TVA's highly successful regional nature), the authority to reverse decisions of the Presidentially-appointed TVA Board would have no apparent purpose, but would unnecessarily risk TVA's remaining ability to continue to provide reliable, low cost power for the Valley.

You don't need to look much further than this summer to see how important this capability is to people in the Valley. Throughout our history, TVA has never had the type of outages that other regions of the country have experienced in recent years. Just a few weeks ago when electric power systems that neighbor TVA and systems across the Eastern interconnection were experiencing substantial problems associated with record demand, TVA provided the electricity necessary to keep businesses running, as well as homeowners' lights and air conditioners on in the Valley.

TVA is now facing a record demand. During a 10-day period in July, TVA surpassed our previous all-time peak demand on eight of those days, including a Saturday. Clearly, we are at the margins in the Valley and need to maintain the flexibility to respond to this growing Valley demand in the future. This is a reason we are particularly concerned by that would hinder TVA's ability to compete to serve the growing demand for electricity in the Valley. For instance, the provision that would impose a requirement that TVA secure all future generation facilities—for the life of those facilities—through contractual arrangements with customers. In practice, that means TVA would be forced to find customers willing to sign long-term (20 to 30 years) contracts tied to specific power plants—not a likely prospect in a competitive marketplace. Effectively, this would prevent TVA from ever pursuing new generation resources to meet the anticipated demand in the Valley. And recent data suggest that this need may arise sooner rather than later.

The TVA service territory has recently experienced about four-percent demand growth for electricity per year. This trend is projected to continue well into the foreseeable future. We do not think their future access to cost competitive power from TVA should be contingent on such a restrictive contractual obligation.

A final consideration is the interpretation that the financial markets might place on Congressional actions taken. Investors now hold all of TVA's debt that finances the power program. Except for the pledge of TVA's power revenues, this is unsecured debt. TVA debt is not backed by the U.S. Government, nor is it supported by mortgages on TVA plant property and equipment—all of which is owned by the U.S. Government. It is secured solely by the sound financial operation of TVA as well as the Bond Covenants and the provisions of the TVA Act.

TVA bondholders place considerable reliance on the fact that the TVA Board not only has the right to set rates, but also has the affirmative obligation to raise rates to the extent necessary to provide the funds for debt service. What this means, to a TVA investor, is that if current operations do not provide sufficient funds for debt service, the ratepayers of the Tennessee Valley will be assessed an increased rate sufficient to do so. If the TVA Board's authority and responsibility to set final rates were subordinated to authority of FERC and State regulatory authorities, there is little question that TVA's financing costs and financial vitality would be unnecessarily placed at risk.

TVA's current low-cost, reliable power in the Valley can be threatened by attempts to make TVA look and behave exactly like an investor-owned utility—which it was never intended to be. Mr. Chairman, I for one think the greatest strength in our electricity industry, particularly as we move to a new marketplace, is its diversity. We have a very broad spectrum of providers, from rural electric cooperatives to the biggest private companies, and from municipal systems to regional Federal power providers. I believe this variety should be embraced and nurtured, not discarded as we move forward. Public power and investor-owned utilities make different, but very important contributions to the strength of our Nation's electric power supply networks. The continued, viable presence of both in a future restructured marketplace will help ensure a reliable power supply for all on an affordable basis.

Conclusion

Mr. Chairman, TVA is working hard to prepare for a restructured future competition by reducing our debt, keeping our electric rates low, and efficiently managing the Tennessee Valley's integrated resource system.

TVA remains committed to work with the Administration, the Congress and TVA stakeholders to determine the nature of the future role that TVA will play in this changing industry.

Thank you for the opportunity to testify before this important hearing.

RESPONSES BY MARK MEDFORD TO ADDITIONAL QUESTIONS FROM SENATOR MCCONNELL

Note. In responding to these questions, TVA is expressing its own views and is not speaking on behalf of the Administration.

Question 1. What is the current level of TVA debt?

Response. As of September 30, 1999, TVA's debt was \$26.4 billion.

Question 2. How much of that total debt is owed to the Federal Government?

Response. None of this debt is owed to the Federal Government.

Question 3. How much does TVA pay the Federal Government annually in debt payments? At that rate, how long would it take TVA to fully satisfy its obligations to the U.S. government? What interest rate is attached to this Federal debt?

Response. None of TVA's outstanding debt is owed to the U.S. Government. Sometimes the U.S. Government's proprietary capital (referred to in the TVA Act as "appropriation investment") in TVA is incorrectly thought to be debt.

As part of the 1959 Self-Financing Amendment to the TVA Act and the cessation of congressional appropriations to fund the TVA power program, the amount of appropriations invested by the U.S. Government was calculated. To provide for the systematic reduction of that appropriations investment (\$ 1.4 billion) over a multi-year period, the TVA Act requires TVA to make annual payments to the U.S. Treasury from net power proceeds of \$20 million, plus an annual "dividend" payment (referred to in the TVA Act as a "return on the appropriation investment") which is calculated by multiplying the outstanding balance of the appropriation investment by the computed average interest rate payable by the U.S. Treasury on its total marketable public obligations as of the same date. As of September 30, 1999, the outstanding balance was \$548 million. Through the combination of these two annual payments to date, TVA has paid to the U.S. Treasury a total of about \$3 billion.

Question 4. What percentage of TVA bonds are in foreign ownership?

Response. TVA began actively marketing its bonds in the international market in 1995. Since that date, 38 percent of globally marketed bonds have been purchased by foreign investors at the time of issuance. However, TVA has no way of knowing whether ownership of these bonds has changed in the secondary market since that time.

Question 5. Of TVA bond issuances, how many issues and how many dollars of bonds were issued abroad?

Response. TVA global bonds are registered on both United States and foreign exchanges, supported in the international secondary market by investment bankers, and marketed to both international and domestic investors to broaden demand and improve pricing.

Since TVA began marketing global bonds in 1995, TVA has issued 8 original global bonds and reopened 2, which has raised more than \$ 10 billion to refinance expiring or callable debt. This represents about half of TVA's total debt issued since 1995.

Question 6. Will TVA increase or decrease its debt level this year? If TVA increases its debt, why will that occur? If TVA decreases its debt level this year, how will it do so? In other words, will it pay off more of the debt it owes the Federal Government or others?

Response. TVA reduced its debt in fiscal year 1999 by \$308 million by generating more cash-flow from operating activities than it reinvested in capital.

Question 7. Every prospectus for TVA bond offerings States that payment of interest or principal of these bonds is not guaranteed by the U.S. Government, however, in a Forbes article on TVA, Chairman Crowell states that if Congress "did anything legislatively that put TVA in a position where it would not succeed, then you end up putting it in a bailout position in which the taxpayers would then have to pick up the debt." If the bonds are not backed by the Federal Government and therefore, the taxpayers of this country, then do TVA's ratepayers have to pay off that debt?

Response. Section 29 of the TVA Act expressly states that no amendment or repeal of provisions of the TVA Act "shall operate to impair the obligation of any contract made by" TVA. However, to the extent that Congress were to enact legislation which would preclude TVA from being capable of paying its debt obligations, some investors may feel that they have a claim against the U.S. Government for any financial damages that they incurred.

Question 8. Assuming, as does the General Accounting Office, that the U.S. Government may ultimately be liable for TVA's debt obligations, does TVA have a REALISTIC, believable idea of how to attack and hopefully decrease its \$27 billion in debt? If TVA does have an updated plan to better manage its debt, please share that plan with the Committee.

Response. As stated in the GAO report, TVA's revised timeframe for reducing the debt by one-half is now 2009. TVA plans to formally update the plan during fiscal year 2000.

Question 9. Some estimates of TVA's waiver from pre-payment penalties of bonds issued to the FFB have put the cost to the Federal taxpayer at \$1 billion. Now that TVA has been allowed this waiver, has TVA reviewed the impact of this waiver on the Federal deficit and U.S. taxpayers against the benefit to TVA? Were the benefits of this waiver passed directly on TVA ratepayers? If so, how and in what form will the benefits accrue to ratepayers in the Valley? If not, why not?

Response. From the time of the enactment of the Self-Financing Amendment to the TVA Act in 1959 until 1974, TVA sold its bonds to the public. When the FFB

was established in late 1973, Congress expressly stated its intent in section 2 of the Federal Financing Bank Act that one of the FFB's central purposes was "to reduce the costs of Federal and federally assisted borrowings." Initially, TVA was hesitant to rely on financing through the FFB because it questioned whether those financings could be more economical than financing in the public debt markets. Eventually, TVA began selling all of its bonds to the FFB.

The FFB had always earned a "margin" on its financing arrangements with borrowers, including TVA, in the form of a one-eighth of 1 percent adder above the U.S. Treasury's comparable cost of money. However, as interest rates rose dramatically in the early 1980's, the FFB became unwilling to agree to provisions which would allow TVA and other borrowers to refinance the FFB debt at face value in exchange for the payment of a "call premium." As interest rates began their dramatic decline in the late 1980's, the FFB's focus turned away from its original mission to reduce Federal agency financing costs and instead became a revenue generator for the Federal Government, receiving interest payments from TVA that over the years were far in excess of the U.S. Treasury's own cost of money. As a result, TVA discontinued any future borrowings from the FFB in 1991.

Beginning in the late 1980's and continuing throughout the 1990's, TVA and various Members of Congress requested the FFB to provide TVA with the right to redeem this debt at its principal value. However, all such requests to the FFB were refused until Congress granted permission to TVA in October 1998 to refinance its FFB debt at its principal value. Significantly, this action by Congress with respect to the FFB's policies was not something unprecedented. It was consistent with earlier actions taken by Congress to provide relief to rural electric cooperatives and various foreign governments from having to continue to pay excessive interest to the FFB.

With regard to the impacts of this legislation on the Federal deficit and the U.S. Treasury, the Federal Government had, of course, benefited from the additional revenues it received over a number of years due to TVA's payment of interest well in excess of market rates. The FFB transferred these TVA bonds several years ago to the Civil Service Retirement and Disability Fund and presumably received the appropriate financial value of those bonds in exchange at the time of the transfer. Due to the enactment of this legislation, the FFB received the full \$3.2 billion principal value of those TVA bonds from TVA and an appropriation of \$1.2 billion to compensate for the calculated amount of premium that TVA would have otherwise had to have paid to be allowed to refinance these bonds early. The total amount was then transferred to the Civil Service Retirement and Disability Fund to make it whole because of the transfer of the TVA bonds out of its investment portfolio. We also note, as commented by Senator Thompson at this Committee's October 6 hearing on TVA, that Congress had decided to discontinue providing appropriations to TVA to carry out the same navigation, flood control, and resource management missions in the Tennessee Valley that continue to be funded with appropriations elsewhere in the Nation and that one purpose of this refinancing proposal was to help mitigate the financial impacts of the approximately \$50 million in added annual expense that the electric power customers in the Tennessee Valley will have to bear in the future due to Congress's decision to stop further appropriations to TVA for these essential stewardship activities under the TVA Act.

Under the provisions of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, which authorized TVA to refinance the FFB debt, TVA is obligated to use the savings it realizes from this refinancing, as calculated using a statutory formula, to reduce TVA's debt. The lower total annual interest expense that TVA incurs as a result of this refinanced and reduced debt benefits TVA's ratepayers.

Question 10. Recently, the Department of Justice initiated an antitrust action against Rochester Gas & Electric for requiring the University of Rochester to buy power from it or lose certain research and development grants. This sounds a lot like what TVA did to 4-County Electric Cooperative and has threatened to do to other distributors who give notice of termination of TVA's contracts. How, if at all, are TVA's activities in this regard different from activities of Rochester Gas & Electric?

Response. The two situations are fundamentally different. There are significant differences between: (1) threatening to withdraw certain things or services of value that were being provided under agreements entered into separately from a proposed agreement "not to compete" and (2) only offering certain things or services of value prospectively to those customers who agree to purchase power in the future under certain terms and conditions which do not involve an agreement "not to compete."

The Rochester situation involved the former. The utility had threatened to cutoff certain research grants unless the university signed a new agreement not to com-

pete against the utility for the utility's customers. The university had otherwise planned to replace an old generating facility, that was meeting part of the university's needs, with a new plant from which the university would also sell surplus power in competition with the utility.

On the other hand, the 4-County situation involved no such agreement "not to compete." At issue was the TVA Growth Credit Program, which was offered up-front to TVA distributors as a benefit in exchange for continuing to be long-term TVA customers. The long-term commitment on the part of the distributor was and continues to be necessary for TVA to derive the corresponding benefits of this program (increased power sales to that distributor over a period of time due to the new or increased loads) to justify the expense of providing such additional benefits to those distributors who elected to participate in that program. When 4-County sued TVA to be allowed to continue participation even though it might discontinue being a long-term TVA customer by giving its termination notice, the court determined that there was no basis for 4-County to claim a right to continue in a program for which it no longer met the program's eligibility criteria.

Question 11. Has TVA ever evaluated its generation market dominance in the wholesale and retail markets in the Tennessee Valley region? Assuming for the purposes of your response, that TVA had generation market dominance, how would TVA propose to mitigate that dominance? If by compliance with open access requirements, how does TVA address the exemption it has under the Energy Policy Act from having to wheel power to distributors located in its service territory. Is that true open access?

Response. For decades, TVA has been the sole source of power supply for the 159 municipal and cooperative distributors which serve the Tennessee Valley, as well as for dozens of industrial and governmental retail customers with large or unusual loads. It is no surprise, therefore, that a substantial majority of total generating capacity in the Valley presently belongs to TVA, although that has begun to change this decade as independent power producers are constructing new power plants to seek to capture the more lucrative sales opportunities in the Eastern United States. TVA does not view its continued ownership of its generating resources and its construction of new generation capacity as in any way impairing wholesale competition in a future restructured marketplace.

As part of the Administration's electric power industry restructuring bill, while the TVA "fence" would be removed, TVA would only sell power that is excess to the needs of the Valley outside the "fence" and only at wholesale. In addition, TVA's wheeling exemption under the Energy Policy Act of 1992 would be repealed at the same time that the "fence" is removed, thereby enabling other suppliers to use the TVA transmission system to compete for loads as wholesale competition comes to the Valley. Moreover, unlike any other utility in the country, TVA would be required to renegotiate its wholesale power supply contracts with all 159 distributors, with regard to the contract term, length of termination notice, ability to purchase from other suppliers on a partial requirements basis, and stranded cost recovery. At present, no distributor in the Valley could purchase power from another supplier earlier than September 30, 2007—and TVA would give distributors opportunities to do that earlier in exchange for satisfactorily providing for stranded cost recovery.

With regard to retail markets, TVA would be prohibited from selling power at retail outside the Valley and to sell power at retail within the Valley only to existing customers or under circumstances within the control of the local distributors.

Question 12. Standard & Poor's credit rating agency recently stated that "were Congress to enact the (Administration's) bill, it may be construed as indicative of diminished Congressional support of TVA debt and could have implications for TVA's rating." This tells me that if Congress were to let you outside the fence today, without a truckload of Congressionally mandated protections and artificial competitive advantages, TVA would swim like a rock and sink rapidly. The S&P statement combined with what GAO recently said, that: "TVA could fully achieve all of the goals and objectives outlined in (its Ten Year Business Plan) plan and still not be positioned to offer competitively priced power in 2007 and beyond." This makes me wonder who is going to ultimately pay for TVA's lack of accountability and lack of responsibility. How do we legislate around a \$27 billion black hole? If we leave the fence up, the ratepayers in the valley will not be happy without customer choice. If we remove the fence and allow TVA to compete, but on a level playing field, TVA will certainly not be able to offer competitively priced power. And we simply cannot remove the fence and allow TVA to compete with all its unnatural and artificial competitive advantages and without any oversight, accountability or responsibility—that would be like allowing the U.S. Air Force to open up terminals and new routes

to compete with Continental, US Airways, United, American, and all other airlines across the country.

Response. With all due respect to Standard & Poor's, TVA fully supports the provisions of the Administration's electric power industry restructuring bill that address TVA's future role in a restructured marketplace and believes that TVA would continue to be a viable market participant in that new marketplace. TVA is equally confident that it is taking the steps necessary to enable TVA to continue to offer competitively priced power in 2007 and beyond. TVA further believes that, given that it is a part of the Federal Government, the appropriate forum for oversight is Congress itself—more specifically this Committee and the House Transportation and Infrastructure Committee—and that such oversight should not focus on how to make TVA look and act like an IOU, but on whether TVA's performance in carrying out its responsibilities under the TVA Act is serving and advancing the public interest.

Allegations of TVA's "unnatural and artificial competitive advantages" (1) are not supportable, (2) are actually directed toward public power suppliers generally (TVA is not unique), (3) ignore that IOUs and public power suppliers each have their own different advantages and disadvantages, and (4) ignore that a diversity of suppliers has made, and will continue to make, the reliability and affordability of electric power supply in the Nation among the very best in the world.

In a restructured marketplace, it is important to stress that, under all major restructuring proposals being considered by Congress, TVA would only be free to sell power outside the "fence" if that power were in excess of the Valley's needs and only at wholesale—primarily for the purpose of mitigating any stranded costs that might result as wholesale competition was introduced in the Valley. The amount of any such excess power, of course, would depend upon the future power supply decisions made by Valley distributors—since TVA cannot unilaterally revise its contractual obligation to meet all of their demands until they exercise whatever rights may be available to them to purchase power from other suppliers. And TVA strongly opposes any legislative proposal that would effectively force any distributors wishing to continue to purchase power from TVA to have to purchase power from other suppliers.

In addition, if comprehensive electric power industry restructuring legislation is enacted which enables TVA to sell excess energy outside the current "fence," TVA has agreed with the Tennessee Valley Public Power Association (TVPPA) to give distributors "Most Favored Nation" status with regard to the terms and conditions of contracts with new wholesale customers for the supply of firm power for a term of 3 years or longer. By doing so, TVA would hardly be free to engage in the type of competitively unfair pricing of wholesale power outside the Valley that some suggest it might attempt in a restructured market. It is significant that a provision to this effect has been included in H.R. 2944, the comprehensive electric power industry restructuring bill introduced by Chairman Barton of the House Commerce Committee's Energy and Power Subcommittee.

Question 13. In TVA's forecasts for future consumption among its customers, how much electricity does it project will be needed to satisfy its customers for the next 5, 10, 20 years?

Response. The consumption of electricity in the existing TVA service territory is projected to reach approximately 162,800 GWh in 5 years, 177,500 GWh in 10 years and 189,300 GWh in 20 years.

Question 14. In TVA's forecasts, how does it anticipate meeting this future load growth?

Response. This future load growth will be met by a number of sources of supply to include greater utilization of existing TVA generation assets, new TVA generation, generation from Independent Power Producers and power distributors, co-generation by large power users, generation by other utilities sold into the region, bulk power marketers, etc.

Question 15. How much of your current capacity do you sell outside the fence, for exchange power or for other reasons?

Response. The only power that TVA sells outside the fence is sold to the 14 utilities that were grandfathered under the 1959 Self-Financing Amendment. Those "grandfathered" utilities have since merged into 12 companies. The vast majority of TVA's off-system sales to these utilities are intermittent sales of exchange energy from TVA generation and other resources that is surplus to the needs of the Valley at any given time. At different times, depending upon the needs of the Valley and the availability of TVA generation and other resources, TVA either has surplus energy to sell to the "grandfathered" utilities or needs to purchase power from other suppliers.

TVA's off-system energy sales in Fiscal Year 1999 totaled about 8.3 billion kilowatt hours or 5.3 percent of TVA's total energy sales.

However, during Fiscal Year 1999, TVA purchased about 9.3 billion kilowatt hours of energy, making it a net importer of energy during the year.

Question 16. If the valley needs more generating capacity and TVA cannot afford any more debt, would TVA be amenable to allowing distributors to own any new generation that may be required? If so, how much?

Response. As TVA renegotiates its existing power contracts to provide for partial requirements, then it follows that TVA would be amenable to distributors owning new generation in order to meet that portion of their requirements that they acquire from sources other than TVA. However, because under partial requirements distributors could choose to supply a portion of their load from a variety of sources, including other wholesalers as well as their own generation, there is not necessarily a one to one correlation between the amount of power not supplied by TVA and distributor-owned capacity. The important consideration is for TVA and distributors to reach agreement on partial requirements in order for TVA to be able to plan properly for the power that distributors will purchase from TVA in the future. In any case, TVA will always focus on working with distributors for the good of the ultimate consumers of TVA power.

Question 17. How would TVA's potential stranded investment be determined? By whom? How would it be calculated?

Response. TVA supports the provisions of the Administration's electric power industry restructuring bill that provide for FERC's approval of an appropriate stranded cost recovery plan for TVA that does not unfairly shift costs among customers. FERC would and should have the flexibility to make decisions on TVA stranded cost recovery that reflect the unique nature of wholesale power supply by TVA to the 159 distributors who serve the Tennessee Valley. One possibility is that FERC may elect to apply its current "lost revenues" calculation formula in TVA's case. That formula is based upon the price at which a utility is able to market capacity "freed up" by customer decisions to purchase from other suppliers. Under FERC's approach, no particular "investment" is stranded per se. TVA stranded "costs" would only come into existence under FERC's "lost revenues" formula if distributors discontinued purchasing certain amounts of power from TVA prior to October 1, 2007, and TVA were unable to obtain an equal or higher price for such power from new wholesale purchasers in sales of such power prior to October 1, 2007.

While the final judgment should be FERC's, it appears at this point in time that fairness to all customers would dictate that TVA's stranded cost recovery be addressed on a system-wide basis by making the "lost revenues" calculation on the basis of the total revenues lost by TVA as a result of the cumulative decisions by distributors to purchase power from others within the same general period of time (recognizing that individual distributors may be making their decisions months apart). Under such an approach, each distributor deciding to purchase power from a source other than TVA would bear its proportionate share of that total amount as its own stranded cost liability.

Question 18. Will the formula that determines that amount be the same for all distributors who leave the TVA system in the future?

Response. That, of course, is a decision that FERC would make under the provisions of the Administration's electric power industry restructuring bill—which TVA supports. TVA believes that the stranded cost recovery plan approved by FERC should not unfairly shift costs among customers. In addition, TVA and TVPPA have expressed interest in the possibility of a "true up mechanism" that would help avoid the creation of "winners" and "losers" in this process. TVA also supports the Administration bill's provision that TVA could not recover stranded costs from any distributor after September 30, 2007, without that distributor's approval.

Question 19. What type of notice has TVA provided to each of its distributors about its plans to seek stranded cost recovery if a distributor attempts to leave the TVA system?

Response. TVA has had informal discussions with some distributors individually as well as with various TVPPA committees such as the Restructuring and Rates & Contracts Committees regarding stranded costs. Beginning in 1997, distributors have had the option to move to the "five and five" contract in lieu of the 10-year rolling term contract. The "five and five" contract contains language which States that stranded cost obligations will be fulfilled as long as the terms of the contract are fulfilled. TVA has also agreed that it would not seek any stranded cost recovery from those distributors who moved to the "five and five" contract beyond September 30, 2007, unless otherwise agreed to between TVA and the distributors.

Question 20. Are distributors going to be freed of stranded costs if they provide TVA with early notice of intent to terminate their contract (i.e. Bristol)? How far in advance would notice have to be given and what kind of charges would TVA impose on distributors that give notice five, seven, or 10 years in advance?

Response. For the 97 distributors who agreed to a modified wholesale power supply contract in 1997 (the "five and five"), there will be no stranded cost liability as long as they fulfill their current contractual obligations to continue to purchase all of their requirements from TVA through September 30, 2007. Under present law, TVA would have the right to seek appropriate stranded cost recovery from any other distributor to the extent permitted under FERC's rules for recovery of stranded costs. Under the Administration's electric power industry restructuring bill, TVA has agreed that, under the terms of a FERC-approved stranded cost recovery plan, it will have no right to recover stranded costs from a distributor after September 30, 2007, unless that distributor approves of such recovery.

Question 21. Would a Congressionally mandated sale of some or all of TVA's assets trigger a right for TVA's distributors to immediately cancel or terminate their power purchase obligations without liability for payment of TVA's stranded investment? If TVA's position is that its distributors would not be liable, please provide a detailed explanation of TVA's legal rationale for this position (referencing contract provisions and related law/statute language).

Response. In such a circumstance, presumably the proceeds from the mandated sale of TVA assets would be applied to reduce TVA's outstanding debt.

However, given that—(1) TVA has binding contractual obligations to supply all requirements of the 159 municipal and cooperative distributors which purchase TVA power and (2) those distributors have the legal right to expect TVA to continue to fulfill those obligations—we find it difficult to imagine that Congress would mandate the sale of any TVA assets that are essential to enabling TVA to meet those supply obligations without also accommodating the distributors' contractual rights. In that regard, Section 29 of the TVA Act expressly states that no amendment or repeal of provisions of the TVA Act "shall operate to impair the obligation of any contract made by" TVA. While Section 29 would not preclude Congress from mandating the sale of TVA assets, it does seem to provide a basis for distributors to rely on the premise that Congress would take no action that would impair TVA's contractual obligations to provide power to them.

To the extent that a congressionally mandated asset sale would make TVA unable to meet its contractual obligations to distributors, aggrieved distributors might have a claim against the U.S. Government for any financial damages that they incurred by having relied on TVA for their power supply and having instead to try to secure sufficient alternative suppliers of electricity due to that action by Congress.

Question 22. If TVA's assets are sold to a third party and TVA's distributors are released from any obligation to take their requirements from that third party and are not liable for TVA's stranded investment, who would bear the stranded investment? Would it be TVA's bondholders or the Federal taxpayers?

Response. In such a circumstance, presumably the proceeds from the mandated sale of TVA assets would be applied to reduce TVA's outstanding debt. What is not clear from the question is whether TVA would be forced to try to meet all of its contractual supply obligations with power purchased from others or whether it is presumed that Congress would also discontinue TVA's role as a power supplier.

In this regard, it is important to stress that: (1) all distributors currently have a contractual right for TVA to supply all of their power requirements; (2) a distributor's wholesale power contract with TVA can only be assigned to another supplier with that distributor's consent (another contractual right); and (3) the largest municipal distributors which have indicated the greatest interest in purchasing power from other suppliers recently testified before the House Energy and Power Subcommittee that, even if they have the ability to purchase power from other suppliers, they envision purchasing at least some of their total requirements from TVA for the foreseeable future.

As such, at least some distributors might view such congressional action as an impairment of their contractual rights and might file claims against the U.S. Government for any financial damages that they incurred in obtaining the necessary power to meet their needs from other suppliers.

Since all TVA capacity would have been sold in this circumstance, there would be no "freed up" capacity to trigger distributor stranded cost liability under FERC's "lost revenues" formula. To the extent that the proceeds from asset sales were insufficient to retire all TVA debt, the remaining bondholders might file claims against the U.S. Government for losses incurred due to an alleged impairment of their contractual rights.

In the absence of any action by Congress, the U.S. Government has no legal obligations to either distributors or bondholders if TVA is unsuccessful in meeting its contractual obligations to those parties. However, by affirmatively taking actions which remove TVA's capability to meet those contractual obligations, Congress might be determined by the courts to have obligated the Nation's taxpayers to assume the financial consequences of any impairment of the contractual rights of those distributors and bondholders.

Question 23. What is the status of current or ongoing contract negotiations between TVA and its distributors? What has been agreed to and on what issues are there disagreements?

Response. In 1997, TVA began working directly with TVPPA, representing distributors, to develop a joint position for inclusion in a legislative proposal. TVA and TVPPA have now submitted a joint recommendation to Members of Congress from the Tennessee Valley region which represents a regional consensus and compromise on what TVA's future role would be in a restructured electric power industry. As part of that regional consensus and compromise, TVA has agreed with TVPPA, within 1 year of the enactment of comprehensive restructuring legislation, to renegotiate the following provisions of all wholesale power supply contracts with distributors: (1) remaining term of the contract; (2) length of the termination notice; (3) amounts and timing of partial requirements, and (4) stranded cost recovery. For stranded cost recovery by TVA from distributors, FERC would make the final decision. In the case of disagreement on one or more of the other three issues, distributors would have the right to terminate their contract with TVA upon 3 years' notice.

Question 24. TVA has 10 year full requirement contracts with its distributors, complete with 10 year notice of termination provisions, does it not? What is the purpose of the 10 year notice provision? Can private utilities regulated by antitrust laws have similar long-term notice of termination provisions in their contracts?

Response. TVA currently has full requirements contracts with all of its distributors. Beginning in 1989, all distributors, with the exception of Bristol, Virginia, opted for contracts with 10-year notice of termination provisions. The purpose of the 10-year notice provision was to provide TVA with the appropriate lead time to make decisions regarding base load capacity because, at that time, the planning horizon for new base load plants was approximately 10 years. Beginning in 1997, distributors can opt for "five and five" contracts in lieu of the 10-year rolling term contracts. 97 distributors have opted for the "five and five" which, beginning in October, 2002, provides for a 5-year termination notice. Private utilities have wholesale power supply contracts with termination provisions with similar or longer advance notice requirements.

Question 25. What sort of non-power resources, such as economic development assistance, does TVA make available to its distributors? Are these the sort of resources that TVA declines to provide if a distributor gives notice of cancellation or termination of their contract with TVA? If TVA's broader mission is to help develop the economy of the Tennessee Valley and to help develop all natural resources of the Tennessee Valley, why does TVA tie availability of such assistance to the purchase of power? Has TVA effectively abandoned its original mission?

Response. TVA provides a variety of resources to power distributors and their customers including community development assistance, financing assistance, incentive rates and credits, technical assistance and marketing programs. It is important to stress that all of these resources are currently paid for with TVA power funds and, hence, there must be a commensurate benefit to the power system to warrant such expenditures of power funds.

Certain of these programs constitute investments in economic development of distributors' service territory that take years in order to provide the level of benefits (in the form of increased distributor loads which would be supplied by TVA) necessary to justify the amount of power funds expended. Only if distributors agree to remain long-term customers of TVA does the TVA power system have the ability to recoup its investment, and distributors electing to participate in such economic development programs understand up front that that is what is necessary for them to qualify. Therefore, under the provisions of these programs, if a participating distributor chooses to give notice of contract termination, that distributor becomes ineligible to continue to participate in the program.

The application of program benefits in this fashion in no way minimizes or contradicts the original mission of TVA, which includes the economic development of the Valley. Congress's decision several years ago to discontinue providing appropriations for TVA economic development programs has required that TVA limit itself to funding those economic development activities that are of value to the TVA power system, as well as to the Valley in general. The reliance on power funds to finance

the economic development programs makes it necessary for TVA's power customers, who are paying for these costs in their electric power rates, to receive sufficient benefits in return. Expending funds for economic development that would only benefit non-TVA customers would not meet this test and would be unfair to TVA ratepayers.

Question 26. During all of your discussions about the future of TVA, is there ever any discussion or attempt at valuation of the TVA assets? What is the current book value of all of TVA's assets, both generating and transmission, and what, approximately, would those assets yield if they were sold in today's market? Please include the assumptions used to derive this market value.

Response. The value of generation assets is primarily dependent on the projection of the future market price of power. There is currently no consensus or market-transparent long-range projection upon which to base such a valuation. Therefore, any projection of market prices would be speculative at best. For example, a 1998 study by the Congressional Budget Office (CBO) stated that the "market value" of TVA's assets is highly uncertain. The CBO estimated that selling TVA's assets would produce a value that could range from a gain of \$2 billion to a loss of \$6 billion.

TVA's net book value of property, plant and equipment as of September 30, 1999 was \$28.4 billion and total assets were \$33.4 billion.

Question 27. Has any independent regulatory authority ever found that TVA's \$8.5 billion investment in non-producing power production capacity was prudent or was (or is) used and useful for the public's service? If not, then should not TVA undergo an initial fact-finding by FERC to establish a baseline of prudent investment by which FERC could then apply stranded cost principles? Would an investor-owned utility that has wasted \$8.5 billion in a never-used or useful plant, that has never been recovered in rates, be allowed to recover that amount as stranded costs? If not, why should TVA be given special treatment?

Response. While no independent regulatory authority per se evaluated the prudence of TVA's power facility construction decisions, it should be stressed that, in enacting legislation to increase TVA's bond ceiling by \$15 billion in 1979, both the Administration (which proposed the bond ceiling increase) and Congress reviewed TVA's power supply and demand forecasts for the Valley and the proposals for all of those new generating facilities required to meet the Valley's projected needs for power. Included among those facilities were all of those which were later either canceled or placed in deferred status.

Under FERC's "lost revenues" formula, there would have to be "freed up" capacity which TVA would have to market elsewhere as a consequence of a distributor's decision to purchase power from others before that distributor could have stranded cost liability. To the extent that certain investments were not being recovered in TVA's rates for the sale of the electricity from that "freed up" capacity at the time stranded cost liability was determined, those investments already would not have an impact on a distributor's stranded cost liability. However, to the extent that the costs of such investments were being recovered in TVA's rates, there is no fair or rational basis for artificially excluding that cost recovery from the TVA rate to be used in the "lost revenues" formula.

Unlike IOUs, TVA has no stockholders to whom regulatory authorities typically allocate the financial burdens of uneconomic investments. Therefore, all costs incurred by TVA must be borne by TVA ratepayers. Using any hindsight-based prudency review of certain TVA

investment decisions for the purpose of artificially excluding some costs from the determination of the stranded cost liability of departing customers would inappropriately and unfairly transfer those costs to TVA's remaining customers.

Question 28. Does TVA follow "least-cost planning" when it evaluates the need to build or buy when planning to meet growth in demand?

Response. Yes, in accordance with the requirements of section 113 of the Energy Policy Act of 1992.

Question 29. What redress, if any is available for retail and wholesale customers of TVA for alleged breaches of power sale commitments? Can TVA be taken to court for breach of power sale contracts? Can customers complain to FERC? If there is no means for judicial or regulatory redress, what would be a good solution to give these customers certainty that TVA will stand by its contractual commitments?

Response. While it is true that the TVA Board's determinations of wholesale power rates are not reviewable, there is no doubt that TVA retail and wholesale customers can take TVA to court for any alleged breach of a power sale contract and obtain appropriate remedies if the court determined that TVA had in fact breached its contractual obligations. FERC does not have jurisdiction over TVA power sales

contracts, and—given the availability of judicial redress—no such jurisdiction is necessary or appropriate.

Question 30. In an article September 17, 1999, in the Chattanooga Times/Free Press, it was reported that “TVA expects to end the current fiscal year with a net income of \$119 million and pay down its debt by \$306 million.” Is \$306 million debt retirement for this fiscal year correct? Is this not way short of what is needed to be near the TVA Ten Year Plan or even GAO’s suggested 10 now 12-Year Plan? What is TVA’s revised plan to reduce its’ debt in a timely manner, and is this plan sufficient for TVA to be competitive in the future?

Response. TVA reduced its debt by \$308 million for fiscal year 1999. While this amount was below what TVA originally anticipated in its Ten Year Plan, the plan was designed to ensure that TVA would be in a position to deliver electricity to its customers at prices that would remain competitive in the future deregulated utility industry. Reducing the debt by half was a strategy to attain the goal, not the goal itself.

As stated in the Chattanooga Times/Free Press article which is referred, “. . . the debt will remain higher than forecast in the 10-year plan because of bigger-than-expected increases in spending for new generation and air pollution controls. Those expenditures should not hurt TVA’s competitiveness, however. The extra generation reflects TVA’s robust 4 percent growth in annual sales—a pace that is nearly twice the national average. Air pollution control measures are being required of all utilities under recent Federal amendments to the Clean Air Act.”

The GAO report also stated that “. . .since it is not possible to accurately predict what the market price of power will be in 2007, TVA could still achieve its objective of offering competitively priced power, even if it does not fully achieve the plan’s other goals and objectives.”

TVA remains on track in meeting the goal of providing competitively priced power in the future restructured electric power industry.

RESPONSES BY MARK MEDFORD TO ADDITIONAL QUESTIONS FROM SENATOR INHOFE

NOTE. In responding to these questions, TVA is expressing its own views and is not speaking on behalf of the Administration.

Question 1. Why doesn’t TVA think that the stranded cost formula that FERC applies to public utilities should apply to its own stranded costs?

Response. TVA’s position, consistent with the Administration’s comprehensive electric power industry restructuring bill, is that FERC should have the flexibility to consider the unique nature of wholesale power supply in the Valley when deciding the appropriate approach to awarding stranded costs to TVA. At present, FERC’s rules are designed to address, on a case-by-case basis, the very discrete impacts of a decision by one wholesale customer to discontinue purchasing power at the end of a contract with a supplier.

Because TVA would be required under the Administration’s Bill to renegotiate, within a one-year period, all wholesale supply contracts with 159 separate distributors (none of which may otherwise purchase power from any other supplier earlier than September 30, 2007), there are several reasons why FERC should retain the flexibility to exercise its own judgment in this regard and why that flexibility is important to ensure fairness to all customers in the Tennessee Valley.

- Unlike in other regions of the country, the vast portion of power supplied in the Tennessee Valley is at wholesale, exclusively by TVA. Consequently, the financial impacts caused by numerous separate distributor decisions, potentially creating large amounts of “freed up” capacity on a cumulative basis, are far more profound for TVA’s overall operations, and for those customers who continue to purchase power from TVA (who are likely to be small or rural customers), than they are for IOUs (which are substantially retailers and less impacted by wholesale customer decisions).

- Most TVA stranded cost issues would likely be presented to FERC in the context of partial requirements decisions made by 159 different municipal and cooperative distributors of TVA over a period of time. FERC’s consideration of the entirety of stranded cost recovery in the context of a plan—as opposed to numerous case-by-case determinations made at the time of individual decisions—would be the best approach for ensuring that all TVA customers are treated fairly, as well as being more administratively workable for all parties concerned. The rules FERC applies to IOUs do not make provision for such a system-wide plan approach—largely because no IOUs share TVA’s overwhelming wholesale nature. For example, many IOUs sell less than 10 percent of their power at wholesale, while TVA sells approximately 85 percent of its power at wholesale.

- TVA and distributors have expressed interest in the possible implementation of a stranded cost recovery plan with a “true up” mechanism that would help prevent creating “winners” and “losers” as markets change during the stranded cost recovery period. There is no provision for such a “true up” mechanism in the rules FERC applies to IOUs. FERC should retain the flexibility to consider and approve such a plan if it deems it fair and appropriate.

Question 2. Why don't you think that FERC should have jurisdiction over TVA's wholesale sales? TVA has argued that it makes no sense for one group of Presidential appointees to review the rates set by another, but isn't TVA the only Federal electric utility that is completely self-regulated? Why should TVA be subject to any less oversight than the Bonneville Power Administration? Isn't TVA already subject to Federal environmental regulations pursuant to the jurisdiction of the Environmental Protection Agency?

Response. There is no obvious benefit for TVA's customers to be achieved by subjecting TVA's wholesale rates to FERC. It is TVA's perspective that such FERC jurisdiction risks higher electric power rates for the citizens and businesses of the Tennessee Valley Region, and TVA steadfastly opposes any proposal that would so unnecessarily increase Valley power rates.

Unlike IOUs, TVA is a public entity dedicated to meeting the public good, rather than increasing the wealth of stockholders. Unlike BPA and the PMAs, TVA is not only headed by one Presidential appointee confirmed by the Senate, but by a Board comprised of three such Presidential appointees. The members of the TVA Board are expressly charged under the TVA Act to use their collective personal judgment to set power rates “as low as are feasible”—a different standard from that which FERC is required to use in its review of wholesale power rates.

It makes no sense, at a time when the industry is moving to less regulation, to subject the single most important decision to be made by one group of Presidential appointees to review by another—let alone one which is obligated to use a different standard from that which the TVA Board is obligated to use.

Question 3. The Bonneville Power Administration has successfully renegotiated long-term power contracts with a majority of its existing preference customers. Why hasn't TVA been able to achieve similar results? Is there any real difference between a contract that requires 10 years' notice of termination and a contract terminable on 5 years' notice only after a 5-year waiting period? Is this the kind of flexibility that TVA had in mind when TVA pledged, in its Ten-Year Plan, to work with customers that were seeking “more flexible” contracts?

Response. We are not familiar with the details of BPA's contract renegotiation efforts or the issues involved.

In 1997, TVA offered an alternative contract arrangement to power distributors whereby they could elect to enter into a contract which, effective 5 years after the date of execution, could thereafter be terminated upon giving a 5-year notice (the “five and five”). And 97 of the total of 159 distributors of TVA power elected this option and are currently 2 years into the initial 5 year period.

Additionally, under the Administration's bill, TVA would begin negotiating certain key features of all of its wholesale power contracts with distributors on the date of enactment of comprehensive electric power industry restructuring legislation. If TVA and a distributor failed to reach agreement on a contract within 1 year following enactment, that distributor would thereafter have the right to terminate its existing power supply contract with TVA by giving a 3-year notice.

Most distributors who did not agree to the “five and five” contract continue to purchase power from TVA under the 10-year contract, which is substantially different from the “five and five” contract. The 10-year contract has a rolling 10-year term and, therefore, may only be terminated by giving a 10-year notice.

The “five and five” contract was one of the efforts planned in 1997 to accommodate customers seeking more flexible contracts. TVA has continued negotiations with TVPPA and its members over the last 2 years to address further contract options.

Question 4. Can the cost of facilities not being used to serve TVA's customers truly be considered “stranded costs”? Doesn't the term “stranded costs,” as used by FERC, refer specifically to costs stranded as a result of the transition to wholesale electric competition, and not simply to utilities' uneconomic assets and/or investments?

Response. Under the present terms of TVA's wholesale power supply contracts with distributors, the earliest any distributor may discontinue purchasing all of its requirements from TVA is September 30, 2007. When TVA offered distributors shorter termination notice contract terms (the “five and five”) in 1997, it was agreed that, for those distributors who signed the “five and five,” there would be no stranded cost

liability after September 30, 2007. This agreement presumed that each distributor would continue to purchase all of its power requirements from TVA through that date. TVA has also agreed, as part of the Administration's electric power industry restructuring bill, that distributors would not be liable for stranded costs after September 30, 2007.

In determining stranded costs, FERC does not examine the power supplier's assets. Under FERC's "lost revenues" approach to calculating stranded costs, TVA would only be entitled to recover additional amounts from a distributor as stranded costs if: (1) that distributor purchased some or all of its requirements from another supplier prior to September 30, 2007, and (2) TV A were unable to market the capacity "freed up" by that distributor's decision at a price at least as high as the price that would otherwise be paid by that distributor.

Consequently, irrespective of the quality or nature of TVA's power assets, if the two above factors are met, the distributor should be liable for stranded costs. If that distributor is not liable for stranded costs in such a case, those costs (in the form of lost revenues) would unfairly have to be borne by TVA's remaining customers.

Question 5. Should TVA's wholesale customers and their retail ratepayers be required to finance TVA's activities overseas? If so, why?

Response. TVA's overseas activities are either: (1) activities which benefit the power program (and, hence, benefit ratepayers); or (2) activities for which TVA's costs are reimbursed, at no expense to ratepayers, by others who benefit from such activities. The major example of an activity that benefits the power program and ratepayers are TVA's global financing activities—which reduce TVA's overall financing costs.

Question 6. TVA's Ten-Year Plan called for reduced capital expenditures, including a self-imposed ban on capital expenditures for new generation. Last month, David Smith, TVA's Chief Financial Officer, told Congress that TVA would need to build new generation in order to meet its distributors' needs in the future. Given that capital expenditures reduce TVA's available cash and therefore reduce the funds available to pay down TVA's enormous debt, aren't there other ways of meeting distributors' power needs? Why couldn't TVA permit distributors to self-generate some of the power necessary to meet their native load growth? Further, if the statutory barriers to a competitive wholesale electric market in the Tennessee Valley were removed, couldn't the distributors maintain adequate power supplies by purchasing some of their needs, if it were necessary and economical to do so, from suppliers other than TVA?

Response. TVA's Ten-Year Plan did not include a self-imposed ban on capital expenditures for new generation. On page 8, the Plan states "... TVA will need additional power to meet the demand resulting from growth in the Valley over the next 10 years. The decision whether to purchase the power or increase existing capacity will be made at the appropriate time, based on the economics of the projects and the level of certainty surrounding the load forecasts."

TVA's Plan recognized that there would be economic choices to make along the way which could require additional capital investment to achieve a lower cost of power or to increase system reliability. The recent decision to add certain amounts of peaking capacity was one such example.

TVA believes that the experience of the past two summers, where utilities reached all-time peaks and transmission constraints affected the ability of utilities to move power across the grid, which resulted in rolling blackouts in some areas, further supports the decision to place additional generating resources inside the Valley.

STATEMENT OF AUSTIN CARROLL, ON BEHALF OF THE TVA KENTUCKY MANAGERS' ASSOCIATION

Mr. Chairman, members of the Committee, my name is Austin Carroll and I am General Manager of the Hopkinsville, KY Electric System. I am here today on behalf of the Kentucky Managers' Association, which is the group of 18 not-for-profit municipal and rural electric cooperative utilities in Kentucky that buy 100 percent of their power supply from the Tennessee Valley Authority. On behalf of the Kentucky TVA distributors I appreciate the opportunity to present our views on S. 1323 as introduced by Senator McConnell and Senator Bunning.

Let me begin by thanking Senator McConnell for the effort he has made to try to protect the interests of consumers in Kentucky and the Tennessee Valley. As consumer-owned utilities, our primary mission is to keep electric rates as low as possible for our consumer-owners and we appreciate the senator's openness to our views and concerns.

The Kentucky Managers Association supports the intent of some of the provisions of S. 1323, but disagrees with others. We have discussed this thoroughly with Senator McConnell's office and he is aware of these concerns, which I will discuss in more detail in a moment.

Fundamentally, however, we believe that many of the issues raised in S. 1323 are directly related to the question of the role of TVA in a "restructured" or more competitive electric utility industry and are best addressed in a comprehensive TVA title to a Federal restructuring bill. Therefore, we cannot endorse S. 1323 as it is presently drafted.

The KY Managers, acting through the Government Relations Committee and the Board of Directors of our regional trade association, the Tennessee Valley Public Power Association (TVPPA), has been working for the last 3 years to develop a comprehensive set of policy recommendations on TVA restructuring. Those recommendations have been turned into a draft "TVA title" that could be incorporated into a Federal restructuring bill. A copy of that draft title is attached to my written testimony.

In the process of developing that draft, TVPPA worked with TVA and with all distributors to try to reach consensus on a single draft title. While we still have a few areas of disagreement on policy and wording, we are in substantial agreement that changes are needed in the contractual relationship between TVA and the distributors and in the wholesale electric market in the region. We think this is a significant achievement.

Specifically, we agree with provisions that:

- Take down the "fence" to allow TVA to sell excess power at wholesale outside the region. At the same time, the "anti-cherry picking" provisions of the Energy Policy Act of 1992 should be repealed to allow outside suppliers to sell power at wholesale inside the Valley;
 - Allow current restrictive, long-term wholesale contracts between TVA and the distributors to be shortened and modified to give distributors the right to purchase all or portions of their wholesale power and energy from other suppliers;
 - Subject the rates, terms and conditions relating to use of TVA's transmission system to regulation by FERC to ensure open, non-discriminatory access by distributors and others;
 - Allow FERC to determine TVA's stranded costs, if any, resulting from shortened or canceled contracts prior to October 1, 2007 using the same standards and rules that apply to other utilities but ensuring that costs are not shifted among customer groups;
 - Eliminate TVA's retail ratesetting authority over distributors and allow those not-for-profit municipal and cooperative utilities to be regulated at the local level by local citizen boards, as they are in most States; and
 - Apply Federal anti-trust laws to the TVA power program as they are applied to local governmental entities, without the financial penalties that would burden our consumers.
 - Limit TVA sales outside the Valley to wholesale excess energy transactions;
- and
- Limit TVA retail sales inside the Valley to existing customers. Any new retail sales would be allowed only under restrictions agreed upon with distributors and if those sales would not bypass local distribution facilities.

We hope it is clear from this description that TVPPA and the distributors are not burying our heads in the sand and pretending that utility restructuring will "just go away."

We recognize that the utility industry is moving toward greater competition and that all utilities must adapt to the changing environment. We also know that Congress has the authority to require changes in TVA and hope that those in the Valley will be allowed to help shape the changes.

At the same time, we believe that significant changes to TVA's operations or mission must be dealt with comprehensively, in the context of an overall Federal restructuring bill.

Overall, we believe that TVA has been good for the Valley. For more than 60 years, TVA has provided reliable, reasonably priced power for consumers and has promoted the economic development of the Valley. We don't want to make piecemeal changes to TVA that result in higher costs for consumers or that undermine its ability to be a competitive source of power for the future.

Let me turn now to the specifics of S. 1323:

- We think that the "lynchpin" of any TVA restructuring bill must be opening the Valley to wholesale competition through repeal of the "fence" and "anti-cherry picking" provisions of current law. S. 1323 is silent on these issues;

- We believe that for consumers to benefit from opening the Valley to wholesale competition, TVA must be allowed to develop new resources to meet electric demand in the Valley without restrictions that do not apply to other potential suppliers. Section 5 of S. 1323 effectively makes TVA the power supplier of last resort, rather than a viable and reliable source of power for Valley. Further, it would require the distributors to sign long-term contracts for TVA power at a time when we are seeking more flexibility through short-term contracts. We think these limitations are incompatible with today's market and we cannot support them.

- We agree that TVA's transmission system should be subject to FERC jurisdiction but do not support FERC jurisdiction over TVA's wholesale rates. We support a position which would require TVA and any distributor that is unhappy with a proposed rate to participate in an alternative dispute mechanism in the Valley to try to resolve the dispute.

- We support application of Federal antitrust laws to TVA in the same way they apply to State and local governments and do not support assessing monetary damages against TVA. Those costs would be passed directly on to consumers and it is unfair to shift these costs to consumers who would ultimately have to pay for them in the TVA rate base.

- We support directing FERC to determine TVA's stranded costs, if any but do not think requiring "Monday morning quarterbacking" of past investments serves any useful purpose.

- We agree with the limitations proposed on future TVA retail sales inside the Valley and appreciate the inclusion of TVPPA's language on this issue.

- We agree that TVA should not be allowed to recover in rates any of those costs associated with off-shore ventures or that are not activities that benefit the distributor. The language needs to be clarified to make sure it does not apply to TVA's economic development activities inside the Valley.

- We support requiring full disclosure by TVA of information that other publicly owned power suppliers are required to provide.

Mr. Chairman, Senator McConnell, I believe my statement covers the major provisions of S. 1323. I would be happy to answer any questions the Committee may have.

106TH CONGRESS
1ST SESSION

S. 1323

To amend the Federal Power Act to ensure that certain Federal power customers are provided protection by the Federal Energy Regulatory Commission, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 1, 1999

Mr. MCCONNELL (for himself and Mr. BUNNING) introduced the following bill; which was read twice and referred to the Committee on Environment and Public Works

A BILL

To amend the Federal Power Act to ensure that certain Federal power customers are provided protection by the Federal Energy Regulatory Commission, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “TVA Customer Protec-
5 tion Act of 1999”.

6 **SEC. 2. INCLUSION IN DEFINITION OF PUBLIC UTILITY.**

7 (a) IN GENERAL.—Section 201(e) of the Federal
8 Power Act (16 U.S.C. 824(e)) is amended by inserting be-

1 fore the period at the end the following: “, and includes
2 the Tennessee Valley Authority”.

3 (b) CONFORMING AMENDMENT.—Section 201(f) of
4 the Federal Power Act (16 U.S.C. 824(f)) is amended by
5 striking “foregoing, or any corporation” and inserting
6 “foregoing (other than the Tennessee Valley Authority) or
7 any corporation”.

8 **SEC. 3. DISPOSITION OF PROPERTY.**

9 Section 203 of the Federal Power Act (16 U.S.C.
10 824b) is amended by adding at the end the following:

11 “(c) TVA EXCEPTION.—This section does not apply
12 to a disposition of the whole or any part of the facilities
13 of the Tennessee Valley Authority if—

14 “(1) the Tennessee Valley Authority discloses to
15 the Commission (on a form, and to the extent, that
16 the Commission shall prescribe by regulation) the
17 sale, lease, or other disposition of any part of its fa-
18 cilities that—

19 “(A) is subject to the jurisdiction of the
20 Commission under this Part; and

21 “(B) has a value of more than \$50,000;
22 and

23 “(2) all proceeds of the sale, lease, or other dis-
24 position under paragraph (1) are applied by the

1 Tennessee Valley Authority to the reduction of debt
2 of the Tennessee Valley Authority.”.

3 **SEC. 4. FOREIGN OPERATIONS; PROTECTIONS.**

4 Section 208 of the Federal Power Act (16 U.S.C.
5 824g) is amended by adding at the end the following:

6 “(c) TENNESSEE VALLEY AUTHORITY.—

7 “(1) LIMIT ON CHARGES.—

8 “(A) NO AUTHORIZATION OR PERMIT.—

9 The Commission shall issue no order under this
10 Act that has the effect of authorizing or permit-
11 ting the Tennessee Valley Authority to make,
12 demand, or receive any rate or charge, or im-
13 pose any rule or regulation pertaining to a rate
14 or charge, that includes any costs incurred by
15 or for the Tennessee Valley Authority in the
16 conduct of any activities or operations outside
17 the United States.

18 “(B) UNLAWFUL RATE.—

19 “(i) IN GENERAL.—Any rate, charge,
20 rule, or regulation described in subpara-
21 graph (A) shall be deemed for the purposes
22 of this Act to be unjust, unreasonable, and
23 unlawful.

24 “(ii) NO LIMITATION ON AUTHOR-
25 ITY.—Clause (i) does not limit the author-

1 ity of the Commission under any other pro-
2 vision of law to regulate and establish just
3 and reasonable rates and charges for the
4 Tennessee Valley Authority.

5 “(2) ANNUAL REPORT.—The Tennessee Valley
6 Authority shall annually—

7 “(A) prepare and file with the Commission,
8 in a form that the Commission shall prescribe
9 by regulation, a report setting forth in detail
10 any activities or operations engaged in outside
11 the United States by or on behalf of the Ten-
12 nessee Valley Authority; and

13 “(B) certify to the Commission that the
14 Tennessee Valley Authority has neither recov-
15 ered nor sought to recover the costs of activities
16 or operations engaged in outside the United
17 States by or on behalf of the Tennessee Valley
18 Authority in any rate, charge, rule, or regula-
19 tion on file with the Commission.”.

20 **SEC. 5. TVA POWER SALES AND PROPERTY VALUATION.**

21 (a) IN GENERAL.—Part II of the Federal Power Act
22 (16 U.S.C. 824 et seq.) is amended by adding at the end
23 the following:

1 **“SEC. 215. TVA POWER SALES.**

2 “(a) IN GENERAL.—The Tennessee Valley Authority
3 shall not sell electric power to a retail customer that will
4 consume the power within the area that, on the date of
5 enactment of this section, is assigned by law as the dis-
6 tributor service area, unless—

7 “(1) the customer (or predecessor in interest to
8 the customer) was purchasing electric power directly
9 from the Tennessee Valley Authority as a retail cus-
10 tomer on that date;

11 “(2) the distributor is purchasing firm power
12 from the Tennessee Valley Authority in an amount
13 that is equal to not more than 50 percent of the
14 total retail sales of the distributor; or

15 “(3) the distributor agrees that the Tennessee
16 Valley Authority may sell power to the customer.

17 “(b) RETAIL SALES.—Notwithstanding any other
18 provision of law, the rates, terms, and conditions of retail
19 sales of electric power by the Tennessee Valley Authority
20 that are not prohibited by subsection (a) shall be subject
21 to regulation under State law applicable to public utilities
22 in the manner and to the extent that a State commission
23 or other regulatory authority determines to be appro-
24 priate.

25 “(c) ASSURANCE OF ADEQUATE ELECTRIC GENERA-
26 TION CAPACITY.—

1 “(1) IN GENERAL.—Notwithstanding any other
2 provision of law, after the date of enactment of this
3 section, the Tennessee Valley Authority shall not
4 construct or acquire by any means electric genera-
5 tion capacity, or sell the output of electric generation
6 capacity constructed or acquired after that date, un-
7 less the Commission has issued to the Tennessee
8 Valley Authority a certificate of public convenience
9 and necessity authorizing the construction or acqui-
10 sition of electric generation capacity.

11 “(2) CRITERIA FOR ISSUANCE OF CERTIFI-
12 CATE.—The Commission shall issue a certificate of
13 public convenience and necessity under paragraph
14 (1) only if the Commission finds, after affording an
15 opportunity for an evidentiary hearing, that—

16 “(A) the reserve power margin of the Ten-
17 nessee Valley Authority for the area within
18 which the Tennessee Valley Authority is per-
19 mitted by law to be a source of supply—

20 “(i) is less than 15 percent; and

21 “(ii) is expected to remain less than
22 15 percent for a period of at least 1 year
23 unless new capacity is constructed or ac-
24 quired;

1 “(B) the Energy Information Administra-
2 tion has submitted to the Commission, with re-
3 spect to issuance of the certificate of public con-
4 venience and necessity, a determination that—

5 “(i) there is no commercially reason-
6 able option for the purchase of power from
7 the wholesale power market to meet the
8 needs of the area within which the Ten-
9 nessee Valley Authority is permitted by law
10 to be a source of supply; and

11 “(ii) the proposed construction or ac-
12 quisition is the only commercially reason-
13 able means to meet the firm contractual
14 obligations of the Tennessee Valley Au-
15 thority with respect to the area within
16 which the Tennessee Valley Authority is
17 permitted by law to be a source of supply;

18 “(C) the electric generation capacity or the
19 output of the capacity proposed to be author-
20 ized will not make the Tennessee Valley Au-
21 thority a direct or indirect source of supply in
22 any area with respect to which the Authority is
23 prohibited by law from being, directly or indi-
24 rectly, a source of supply; and

1 “(D) the electric generation capacity pro-
2 posed to be authorized is completely subscribed
3 in advance for use by customers only within the
4 area for which the Tennessee Valley Authority
5 or distributors of the Authority were the pri-
6 mary source of power supply on July 1, 1957.

7 **“SEC. 216. VALUATION OF CERTAIN TVA PROPERTY.**

8 “(a) EVIDENTIARY HEARING.—Not later than 120
9 days after the date of enactment of this section, notwith-
10 standing any other provision of law, the Commission shall
11 commence a hearing on the record for the purpose of de-
12 termining the value of the property owned by the Ten-
13 nessee Valley Authority—

14 “(1) that is used and useful; and

15 “(2) the cost of which was prudently incurred
16 in providing electric service, as of July 1, 1999, to—

17 “(A) the distributors of the Authority; and

18 “(B) the customers that directly purchased
19 power from the Authority.

20 “(b) PROCEDURES AND STANDARDS.—In making the
21 determination under subsection (a), the Commission shall
22 use, to the maximum extent practicable, the procedures
23 and standards that the Commission uses in making simi-
24 lar determinations with respect to public utilities.

1 “(c) TIMING OF FINAL ORDER.—The Commission
2 shall issue a final order with respect to the determination
3 under subsection (a)—

4 “(1) not later than 1 year after the date of
5 commencement of the hearing under subsection (a);
6 or

7 “(2) not later than a date determined by the
8 Commission by an order supported by the record.

9 “(d) TIMING OF ORDER AWARDING RECOVERY OF
10 STRANDED COSTS.—The Commission may issue an order
11 awarding recovery to the Tennessee Valley Authority of
12 costs rendered uneconomic by competition not earlier than
13 the date on which the Commission issues a final order with
14 respect to the determination under subsection (a).”.

15 (b) TRANSITION.—Not later than 180 days after the
16 date of enactment of this Act, the Tennessee Valley Au-
17 thority shall file all rates and charges for the transmission
18 or sale of electric energy and the classifications, practices,
19 and regulations affecting those rates and charges, together
20 with all contracts that in any manner affect or relate to
21 contracts that are required to be filed under Part II of
22 the Federal Power Act (16 U.S.C. 824 et seq.) (as amend-
23 ed by subsection (a)) and that are in effect as of the date
24 of enactment of this Act.

1 **SEC. 6. FILING AND FULL DISCLOSURE OF TVA DOCU-**
2 **MENTS.**

3 Part III of the Federal Power Act (16 U.S.C. 825
4 et seq.) is amended—

5 (1) by redesignating sections 319 through 321
6 as sections 320 through 322, respectively; and

7 (2) by inserting after section 318 the following:

8 **“SEC. 319. FILING AND FULL DISCLOSURE OF TVA DOCU-**
9 **MENTS.**

10 “(a) IN GENERAL.—The Tennessee Valley Authority
11 shall file and disclose the same documents and other infor-
12 mation that other public utilities are required to file under
13 this Act, as the Commission shall require by regulation.

14 “(b) REGULATION.—

15 “(1) TIMING.—The regulation under subsection
16 (a) shall be promulgated not later than 1 year after
17 the date of enactment of this section.

18 “(2) CONSIDERATIONS.—In promulgating the
19 regulation under subsection (a), the Commission
20 shall take into consideration the practices of the
21 Commission with respect to public utilities other
22 than the Tennessee Valley Authority.”.

23 **SEC. 7. APPLICABILITY OF THE ANTITRUST LAWS.**

24 The Tennessee Valley Authority Act of 1933 (16
25 U.S.C. 831 et seq.) is amended by inserting after section
26 16 the following:

1 **“SEC. 17. APPLICABILITY OF THE ANTITRUST LAWS.**

2 “(a) DEFINITION OF ANTITRUST LAWS.—In this sec-
3 tion, the term ‘antitrust laws’ means—

4 “(1) an antitrust law (within the meaning of
5 section (1) of the Clayton Act (15 U.S.C. 12));

6 “(2) the Act of June 19, 1936 (commonly
7 known as the ‘Robinson Patman Act’) (49 Stat.
8 1526, chapter 323; 15 U.S.C. 13 et seq.); and

9 “(3) section 5 of the Federal Trade Commis-
10 sion Act (15 U.S.C. 45), to the extent that the sec-
11 tion relates to unfair methods of competition.

12 “(b) APPLICABILITY.—Nothing in this Act modifies,
13 impairs, or supersedes the antitrust laws.

14 “(c) ANTITRUST LAWS.—

15 “(1) TVA DEEMED A PERSON.—The Tennessee
16 Valley Authority shall be deemed to be a person, and
17 not government, for purposes of the antitrust laws.

18 “(2) APPLICABILITY.—Notwithstanding any
19 other provision of law, the antitrust laws (including
20 the availability of any remedy for a violation of an
21 antitrust law) shall apply to the Tennessee Valley
22 Authority notwithstanding any determination that
23 the Tennessee Valley Authority is a corporate agen-
24 cy or instrumentality of the United States or is oth-
25 erwise engaged in governmental functions.”.

1 **SEC. 8. SAVINGS PROVISION.**

2 (a) DEFINITION OF TVA DISTRIBUTOR.—In this sec-
 3 tion, the term “TVA distributor” means a cooperative or-
 4 ganization or publicly owned electric power system that,
 5 on January 2, 1998, purchased electric power at wholesale
 6 from the Tennessee Valley Authority under an all-require-
 7 ments power contract.

8 (b) EFFECT OF ACT.—Nothing in this Act or any
 9 amendment made by this Act—

10 (1) subjects any TVA distributor to regulation
 11 by the Federal Energy Regulatory Commission; or

12 (2) abrogates or affects any law in effect on the
 13 date of enactment of this Act that applies to a TVA
 14 distributor.

15 **SEC. 9. PROVISION OF CONSTRUCTION EQUIPMENT, CON-**
 16 **TRACTING, AND ENGINEERING SERVICES.**

17 Section 4 of the Tennessee Valley Authority Act of
 18 1933 (16 U.S.C. 831e) is amended by adding at the end
 19 the following:

20 “(m) PROVISION OF CONSTRUCTION EQUIPMENT,
 21 CONTRACTING, AND ENGINEERING SERVICES.—

22 “(1) IN GENERAL.—Notwithstanding any other
 23 provision of this Act, except as provided in this sub-
 24 section, the Corporation shall not have power to—

25 “(A) rent or sell construction equipment;

1 “(B) provide a construction equipment
2 maintenance or repair service;

3 “(C) perform contract construction work;
4 or

5 “(D) provide a construction engineering
6 service;

7 to any private or public entity.

8 “(2) ELECTRICAL CONTRACTORS.—The Cor-
9 poration may provide equipment or a service de-
10 scribed in subparagraph (1) to a private contractor
11 that is engaged in electrical utility work on an elec-
12 trical utility project of the Corporation.

13 “(3) CUSTOMERS, DISTRIBUTORS, AND GOVERN-
14 MENTAL ENTITIES.—The Corporation may provide
15 equipment or a service described in subparagraph
16 (1) to—

17 “(A) a power customer served directly by
18 the Corporation;

19 “(B) a distributor of Corporation power; or

20 “(C) a Federal, State, or local government
21 entity;

22 that is engaged in work specifically related to an
23 electrical utility project of the Corporation.

24 “(4) USED CONSTRUCTION EQUIPMENT.—

1 “(A) DEFINITION OF USED CONSTRUCTION
2 EQUIPMENT.—In this paragraph, the term
3 ‘used construction equipment’ means construc-
4 tion equipment that has been in service for
5 more than 2,500 hours.

6 “(B) DISPOSITION.—The Corporation may
7 dispose of used construction equipment by
8 means of a public auction conducted by a pri-
9 vate entity that is independent of the Corpora-
10 tion.

11 “(C) DEBT REDUCTION.—The Corporation
12 shall apply all proceeds of a disposition of used
13 construction equipment under subparagraph
14 (B) to the reduction of debt of the Corpora-
15 tion.”.

16 **SEC. 10. AUTHORIZATION OF APPROPRIATIONS.**

17 There are authorized to be appropriated to the Fed-
18 eral Energy Regulatory Commission such sums as are nec-
19 essary to carry out this Act and the amendments made
20 by this Act.

○

GAO

United States General Accounting Office
Report to Congressional Requesters

April 1999

**TENNESSEE VALLEY
AUTHORITY**

**Assessment of the
10-Year Business Plan**





United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-281916

April 30, 1999

The Honorable Bob Franks
The Honorable Marty Meehan
The Honorable Zach Wamp
The Honorable Bob Clement
House of Representatives

This report responds to your June 5, 1998, and September 24, 1998, requests asking us to review the Tennessee Valley Authority's (TVA) 10-year business plan. Increasing competition in electricity markets led TVA management to develop this plan to position TVA to be more competitive by, among other things, reducing its high debt servicing and other fixed costs. Because of concerns about TVA's ability to achieve the 10-year plan's objectives by 2007—when competitive pressures are likely to be greater and when many of TVA's long-term contracts could expire—you asked us to determine whether TVA will be able to reduce debt as envisioned in the plan and whether its goals and assumptions regarding capital expenditures and revenues and expenses are achievable or reasonable.

In order to obtain more information about TVA's competitive position as you consider its role in a deregulating electricity industry, you specifically asked us to determine whether the 10-year plan (1) addresses key issues facing TVA, (2) takes into consideration all applicable costs and revenue sources, (3) contains goals and assumptions that are achievable or reasonable and in line with industry estimates and expectations, and (4) has been updated to reflect significant changes in key goals and assumptions or actual experience. In addition, you asked us, based on our analysis of the plan, to conclude whether TVA is likely to achieve the plan's strategic objectives.

Results in Brief

Implementation of the 10-year plan is moving TVA in the right direction toward its strategic objectives by addressing the key issues it faces—its high fixed financing costs and large investment in nonproducing and other deferred assets¹ that have not been recovered through rates. The plan, which was issued in July 1997, calls for lowering fixed costs by reducing

¹Deferred assets consist of nonproducing nuclear generating units and unamortized regulatory assets. At the time the plan was issued, the balances of these items were \$6.3 billion and \$2.2 billion, respectively. The costs of these assets have been deferred and have not been recovered through rates.

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outstanding debt by about one-half—to about \$14 billion—by 2007. The plan also provides for the recovery through rates of all but about \$500 million of the \$8.5 billion in deferred assets outstanding as of the plan issuance date.

The year 2007 is key for TVA because it expects to face greater competitive pressures by then and because many long-term contracts with customers could expire at about that time. As a result, the plan emphasizes changes designed to enable TVA to offer competitive rates by the end of 2007. The more progress TVA makes toward addressing the key issues it faces while it maintains its legislative protections and before its customer contracts could begin to expire, the better positioned it will be to successfully operate in a competitive market.

While focusing on the right issues, TVA's plan does not fully address certain costs. Not addressing these costs could jeopardize full achievement of the plan's objectives. Specifically, the plan does not include (1) the capital costs of increasing generating capacity to meet the growth in demand for power as is now currently planned; instead, it provides for meeting the growth in demand for power by purchasing power from other utilities, (2) the cost of complying with new and proposed environmental regulations, and (3) the cost of nonpower programs that were formerly fully funded through appropriations. TVA estimates that these additional costs will total about \$1 billion over the remaining life of the plan and will likely be higher.

We also found that while many of the plan's goals and assumptions were achievable or reasonable, certain of them were not, largely due to the additional expected costs described above. For example, the plan calls for capital expenditures to be limited to about \$600 million per year, which is not feasible given the additional costs that will likely be incurred to comply with new environmental regulations and to invest in new generating capacity to meet growth in demand for power. However, some of these additional costs could be offset by increases in expected market rates of power in 2007. Specifically, since many power producers will incur additional costs for the new and proposed environmental regulations, it is anticipated that the market price of power will increase across the board to help absorb these costs. However, the extent to which different producers will be affected, and the resultant impact on their power prices, is unknown at this time.

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Because of the additional costs not addressed in the 10-year plan, it is unlikely that TVA can reduce its debt to the extent planned by 2007. Estimates in TVA's fiscal year 2000 federal budget request indicate that its debt reduction goal will likely not be achieved until 2009. The added costs will also negatively impact TVA's ability to meet its goal of reducing the balance of its deferred assets, since TVA may not have the ability to begin recovering these costs through rates if it does not sufficiently reduce its other costs first. Achieving these goals is key to TVA meeting its strategic objective of increasing financial flexibility by reducing fixed costs. This in turn is key to its ability to offer competitively priced power in 2007—TVA's ultimate objective.

However, since it is not possible to accurately predict what the market price of power will be in 2007, TVA could still achieve its objective of offering competitively priced power, even if it does not fully achieve the plan's other goals and objectives. Conversely, depending on the market price of power, TVA could fully achieve all of the goals and objectives outlined in the plan and still not be positioned to offer competitively priced power in 2007 and beyond. Nevertheless, any progress it makes toward its goals and objectives will put TVA in a better competitive position.

While TVA has acknowledged major changes to several of the plan's goals and assumptions and has factored these into its internal planning, the 10-year plan has not been formally updated to reflect these changes. Until the plan is formally updated, the Congress and other external users of the plan will not have the current information needed to make policy, oversight, and investment decisions related to TVA. Because of this, we have recommended that TVA (1) move quickly to formally update the plan and (2) periodically report to the Congress and other plan users about its progress toward meeting the plan's objectives.

Background

The Energy Policy Act of 1992 (EPAct) provides TVA with certain protections from competition. Additionally, under the TVA Act of 1933 (TVA Act), as amended, TVA is not subject to most of the regulatory and oversight requirements that must be satisfied by commercial electric utilities; instead, all authority to run and operate TVA is vested in its three-member board of directors. In 1959, the Congress amended the TVA Act by establishing what is commonly referred to as the TVA "fence," which prohibits TVA—with some exceptions—from entering into contracts to sell power outside the service area that TVA and its distributors were serving on July 1, 1957. Under EPAct, TVA is exempt from having to allow other

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utilities to use its transmission lines to transmit power to customers within TVA's service area. This legislative framework generally insulates TVA from direct wholesale competition and, as a result, TVA remains in a position similar to a regulated utility monopoly.

However, TVA is still subject to some forms of indirect competition. For example, TVA has no protection against its industrial customers relocating outside its service area or businesses deciding not to move to its service area for reasons related to the cost of power. In addition, customers can decide to generate their own power. Accordingly, TVA is currently subject to some competitive pressures.

EPAct's requirement that utilities make their transmission lines accessible to other utilities to transmit (wheel) wholesale electricity has enabled wholesale customers to obtain electricity from a variety of competing suppliers and has resulted in increased wholesale competition in the electric utility industry across the United States. This requirement does not apply to TVA if the power is going to be consumed within its service territory. Most of TVA's sales are wholesale because they are to its power distributors. In addition, continuing deregulation efforts in some states have led to competition at the retail level. Industry experts expect that retail deregulation will continue to occur on a state-by-state basis over the next several years. As this occurs, industrial, commercial, and, ultimately, residential consumers will be able to choose their power supplier from among several competitors rather than from one utility monopoly, as is now the case for long distance telephone service and cellular phones.

Because EPAct exempts TVA from having power wheeled to consumers in its territory, TVA has not been directly impacted by the ongoing deregulation of the electric utility industry to the same extent as other utilities. However, if TVA were to lose its exemption from the wheeling provisions of EPAct, its customers would have the option of obtaining their power from other sources after the expiration of their contracts. Under legislation proposed by the administration to promote retail competition in the electric power industry, which TVA supports, TVA's exemption from the wheeling provisions of EPAct would be eliminated after January 1, 2003. If the legislation is enacted, TVA may be required to use its transmission lines to transmit the power of other utilities for consumption within TVA's service territory. In addition, the proposed legislation would remove the statutory restrictions that prevent TVA from selling power outside its service territory.

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Most of TVA's power is sold to municipal and cooperative power distributors who would be directly affected in the future by retail competition through their customers' ability to choose alternate power suppliers. Further, deregulation and the possibility of TVA losing its legislative protections have made many of TVA's customers more aware of price differences among utilities, raised expectations of lower prices, and increased demands for more competitive pricing.

Because of these ongoing deregulation efforts, TVA management, like many industry experts, anticipates that TVA may lose its legislative protections in the future. Even if TVA does not lose its legislative protections, TVA's management has recognized the need to take action to better position TVA to be competitive in an era of increasing competition and customer choice and, in July 1997, issued a 10-year business plan with that goal in mind. TVA established a 10-year horizon for implementing the key changes outlined in the plan largely because TVA officials expect to be facing greater competitive pressures within that time frame and many of its long-term contracts with customers could begin to expire in 2007. The published plan, which formed the basis of our evaluation, contains three strategic objectives:

- reducing TVA's cost of power in order to be in a position to offer competitively priced power in 2007,
- increasing financial flexibility by reducing fixed costs, and
- building customer allegiance.

In developing the 10-year plan,² TVA set several goals and made certain assumptions about the future.² These goals and assumptions are that

- the future market price of wholesale power will be 3.4 to 3.5 cents per kilowatthour³ (kWh) by 2007;
- annual growth in demand through 2007 will average 2 percent;
- fuel costs will increase 1.7 percent annually through 2007;
- improvements in supply chain management⁴ will save \$50 million annually;

²Dollars discussed in this report are nominal dollars.

³A kilowatthour is 1,000 watthours. A watthour is equal to 1 watt of power applied for 1 hour.

⁴Supply chain management is a comprehensive process that begins with examining the need for the product, progresses through procurement, and ends with utilization or disposition.

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- TVA's labor force will be reduced and additional cost savings will be achieved through the creation of shared services⁵ and other initiatives;
- debt will be reduced by about one-half to about \$14 billion, and the balance of deferred assets will be reduced from \$8.5 billion to \$500 million—TVA's estimated net realizable value of these assets;⁶
- capital expenditures will be limited to about \$600 million annually and increases in demand through 2007 will be met primarily through purchased power;
- \$200 million will be saved annually through cost improvement initiatives primarily related to refinancing Federal Financing Bank (FFB) and public bond debt, pursuing changes to its retirement plan, and improving business processes;
- revenues from power sales will be increased by about \$325 million annually by implementing a rate increase in 1998 and maintaining it through 2007; and
- customer relations will improve through new contract and pricing options.

To implement the 10-year plan, TVA has developed action plans and has linked the goals and objectives of the 10-year plan to its corporate and business unit goals. For example, one of TVA's corporate goals is to lower costs; one of the 10-year plan's strategic objectives is to increase financial flexibility by reducing fixed costs; and the Fossil and Hydro Power business unit's business plan includes a unit goal of maximizing net return by reducing fixed and variable costs.⁷ However, TVA has not yet completed the process of developing performance measures to provide accountability. TVA expects to develop these performance measures later in 1999, business units will be expected to meet performance goals in 2000, and unit managers and TVA executives are expected to be held directly accountable through the use of compensation incentives in 2001.

⁵Shared services involve consolidating similar operations from various business units and thereby reducing duplicative efforts.

⁶While not specifically discussed in the published plan, TVA's supporting materials establish a goal of recovering about \$8 billion in nonproducing nuclear generating units and unamortized regulatory assets (deferred assets) by 2007 in conjunction with its reduction of debt.

⁷Fixed costs (such as interest expense) remain fairly constant and do not fluctuate with the volume of production. Variable costs (such as fuel) fluctuate in the same manner as the volume of production.

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Objectives, Scope, and Methodology

We evaluated the three strategic objectives of TVA's plan and the underlying goals and assumptions for reasonableness, achievability, and completeness. As agreed with your offices, we did not (1) assess whether achieving the objectives of the plan would ensure TVA's future competitiveness or (2) develop independent estimates of key elements of the plan, such as the future market price of power. We relied on comparisons of past performance to future projections, the opinions of industry experts, and economic forecasts made by knowledgeable sources to determine whether the individual components of the plan and the plan as a whole were achievable or reasonable. Additional information on our objectives, scope, and methodology is contained in appendix I.

We conducted our review from June 1998 through April 1999 in accordance with generally accepted government auditing standards. We provided a draft of this report to TVA for comment. While generally agreeing with the report's contents, TVA did provide oral and written comments, which we have incorporated, as appropriate. TVA's written comments are reproduced in appendix II.

Plan Objectives Address Key Issues Confronting TVA

Implementation of the 10-year plan is moving TVA in the right direction and addresses important issues facing TVA: its high fixed financing costs and limited financial flexibility to respond to competitive pressure and the large amount of deferred assets that have not been recovered through rates. These deferred assets, which totaled about \$8.5 billion as of the beginning of the plan period, are primarily the result of investments made since the 1970s in nuclear generating plants that were never put into production. This helped contribute to TVA's large debt, which totaled about \$27 billion as of September 30, 1998, and resultant high fixed financing costs.

TVA's ability to meet its strategic objective of being in a position to offer competitively priced power by 2007 and to improve its financial flexibility hinges largely on its being able to meet its goal of reducing debt by about one-half—to about \$14 billion—by 2007. While not specifically stated in the plan, TVA also plans to recover through rates all but \$500 million of its deferred asset costs by the end of the period covered by the plan.⁸

⁸The remaining \$500 million is TVA's estimate of the net realizable value of its deferred assets at the end of 2007.

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These issues were highlighted in reports⁹ we issued in 1995 and 1997, in which we stated that TVA's annual financing costs and deferred assets were substantially greater than those of the utilities with which TVA would most likely have to compete. We also reported that these high fixed costs and deferred assets would limit TVA's flexibility to adjust its rates in a competitive environment. TVA, through its 10-year plan, is taking steps to address these issues. Other utilities are taking similar actions to prepare for competition. For example, utilities we previously identified as those most likely to compete with TVA are also taking steps to refinance debt at lower interest rates and accelerate recovery of the costs of their regulatory assets. However, as we reported in 1995 and 1997, these other utilities generally have fewer financing costs and deferred assets than TVA, giving them more flexibility to respond to changing market conditions. To the extent TVA recovers the costs of its deferred assets and increases its financial flexibility, it will increase its ability to adjust rates as necessary to meet changing market conditions. TVA's focus on these areas before the full advent of competition is key to its chances of being competitive without legislative protections.

Plan Does Not Include Certain Major Costs

The 10-year plan includes costs that correspond to those incurred in prior years and to those reported by other utilities. In addition, the plan considers costs for Year 2000 compliance¹⁰ and likely environmental expenditures under existing Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and Resource Conservation and Recovery Act (RCRA) regulations.¹¹ However, the plan does not

⁹Tennessee Valley Authority, Financial Problems Raise Questions About Long-term Viability (GAO/ AIMD/RCEJ-95-134, August 17, 1995) and Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses (GAO/AIMD-97-110 and 110A, September 19, 1997).

¹⁰The Year 2000 problem is rooted in the way dates are recorded and computed in many computer systems. For the past several decades, systems have typically used two digits to represent the year—such as "98" for 1998—to save electronic data storage space and reduce operating costs. With this two-digit format, however, the year 2000 is indistinguishable from 1900, 2001 from 1901, and so on. As a result of this ambiguity, system or application programs that use dates to perform calculations may generate incorrect results when working with years after 1999. We verified that TVA's plan had considered the cost for Year 2000 compliance. However, we did not determine whether TVA would be Year 2000 compliant or assess its estimated costs for becoming compliant.

¹¹CERCLA (as amended) governs cleanup of both federal and nonfederal hazardous waste sites. RCRA addresses prevention and remediation of releases of hazardous waste from both current and past industrial operations. As a power producer, TVA has been identified by the Environmental Protection Agency as a potentially responsible party for releases from various sites.

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include certain major costs. Specifically, the plan does not include the following:

- The capital costs of additional generating capacity that may be acquired to meet growth in demand for power. The plan assumes that TVA would meet the increasing demand for power over the plan period by purchasing power from other utilities. The costs of the power purchases are reflected as operating costs in the 10-year plan.
- The cost of complying with new environmental regulations.
- The cost of nonpower programs that, to date, have been funded primarily through appropriations. These appropriations, which amounted to \$70 million in fiscal year 1998, are expected to be substantially reduced or discontinued beginning in fiscal year 2000.

By not including these costs, TVA will have less cash than contemplated in the plan to pay down debt and reduce fixed costs, which could jeopardize full achievement of the plan's objectives.

Plan Does Not Include Costs Associated With Investing in New Generating Capacity

TVA estimates that the demand for peaking power¹² in its service territory through 2007 will exceed its current and planned generating capacity. TVA currently has several options planned or underway to meet a portion of this excess demand, including (1) purchasing new gas-fired combustion turbines, (2) purchasing power that was already under contract when the 10-year plan was issued, (3) modernizing hydro facilities, (4) improving the efficiency of certain existing fossil plants and combustion turbines, (5) contracting for the power from a new lignite¹³ plant, (6) upgrading certain nuclear plants, and (7) issuing a request for proposal for purchasing power generated from renewable resources. TVA projected that these measures would not be sufficient to meet the entire increase in demand, and the 10-year plan assumes that TVA will purchase power from other utilities to make up the difference, which is inconsistent with prior year practices.

However, since the plan was finalized, TVA officials have told us that they plan to evaluate other power supply options and to invest in new capacity if

¹²Peaking units are used to meet the demand for power that exceeds the capacity of generating equipment that is operated to meet normal demand.

¹³Lignite is low-grade coal with high moisture and volatile matter content that is used almost exclusively for electric power generation.

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the resulting long-term increase in costs to produce power (interest and operating expense) would ultimately be less than the cost of purchased power. TVA has already decided to invest in new capacity rather than purchasing power in at least one case—in 1998, TVA announced plans to purchase eight gas-fired combustion turbine units¹⁴ that will be used to replace a like amount of purchased peaking power that was assumed in the original plan.

According to TVA officials, while they expect this decision to result in a positive cash flow by fiscal year 2010, the decision to purchase these units will require about \$65 million more in cash disbursements through 2007 than would have been necessary to purchase a comparable amount of power from other utilities. But, according to TVA's analysis, while acquiring this new generating capacity in lieu of purchasing power will initially increase capital expenditures and thus reduce the amount of cash available to pay down debt, it will also decrease TVA's annual cost of power because it will be less expensive for TVA to operate this new equipment than to purchase a like amount of power from other utilities. Decreasing the cost of power should, in the long term, improve TVA's ability to meet its ultimate objective of offering competitively priced power. In addition, purchasing new generating capacity provides the added benefit of removing the uncertainty of having to rely on another utility for power. Based on our discussions with TVA officials, while it may make economic sense in the long term, additional decisions to increase capacity in lieu of purchasing power from other utilities will likely further reduce TVA's cash available for debt reduction through 2007, thus jeopardizing its ability to fully meet the plan's debt reduction goals by 2007.

Plan Does Not Include Costs of Complying With Environmental Regulations

The 10-year plan does not include estimated costs of complying with recent and proposed environmental regulations because TVA did not believe the costs were estimable at the time the plan was developed. Since that time, some of these costs have become estimable.

In October 1998, the Environmental Protection Agency (EPA) issued a regulation requiring states to develop plans to reduce nitrogen oxide emissions. TVA now estimates that it could spend about \$500 million to \$600 million for capital modifications to its fossil plants to comply with

¹⁴TVA estimates that these new units will produce about 576 megawatts of power each year beginning in fiscal year 2000.

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state plans that would be implemented under this regulation, which is commonly referred to as the NOx SIP Call.¹⁵ The time frame for TVA's compliance with the states' plans is 2003, within the scope of the 10-year plan. In October 1998, EPA also issued a proposed regulation regarding regional haze,¹⁶ which EPA expects to be put into effect during the life of the plan but for which EPA does not expect compliance until after 2004. TVA has estimated that this regulation could require capital expenditures of about \$450 million to \$500 million. It is likely that at least a portion of these costs will be incurred during the time frame of the 10-year plan.¹⁷ Additionally, all of the estimated \$500 million to \$600 million in costs related to the NOx SIP Call will be incurred during the plan time frame and, thus, will negatively impact TVA's ability to meet its cost reduction goals.¹⁸ However, as discussed later, TVA officials told us that they still believe TVA will be in a position to offer competitively priced power in 2007 because these same types of costs will be incurred by many other power suppliers and therefore would tend to increase the future market price of power.

Plan Does Not Include Costs of Nonpower Programs Formerly Funded Through Appropriations

The plan does not include the costs of nonpower programs that historically have been funded through appropriations but now are likely to be funded through power revenues. The plan assumes that TVA will continue to receive appropriations for its nonpower programs, such as flood control and navigation. While this assumption was reasonable when the plan was developed, TVA's nonpower appropriations have been sharply curtailed in recent years, from \$109 million in fiscal year 1996 to only \$7 million in TVA's budget request for fiscal year 2000.¹⁹

¹⁵63 Fed. Reg. 57356, 57401 (1998) (to be codified at 40 C.F.R. pt. 51).

¹⁶63 Fed. Reg. 56304 (1998) (to be codified at 40 C.F.R. pts. 52 and 98) (proposed Oct. 21, 1998). Regional haze concerns visibility problems from airborne particles.

¹⁷TVA estimates that the impact of the NOx SIP Call and regional haze regulation on the future market price of power would be to increase it by up to .3 cents per kWh. As is discussed later, this also impacts TVA's projection for its target price of power in 2007.

¹⁸In addition to the EPA regulations, the Kyoto Protocol—an international treaty to reduce net emissions of certain greenhouse gases—could impact the future market price of power. Because the treaty has not been ratified, the methods to be used and time frame for compliance have not been established. Therefore, the 10-year plan appropriately does not address costs related to the treaty.

¹⁹As of April 21, 1999, the appropriations bill containing TVA's requested appropriations had not been passed.

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TVA officials have indicated publicly that future appropriations for nonpower programs are likely to be eliminated or substantially reduced and, in accordance with the fiscal year 1998 Energy and Water Development Appropriations Act, have indicated they will use power revenues to continue these nonpower activities. These costs totaled approximately \$70 million in fiscal year 1998 and are expected to range from about \$50 million to \$60 million annually in the future.²⁰ Since funding nonpower activities with power revenues was not assumed in the 10-year plan, these costs will further reduce the cash available to reduce debt to the level envisioned in the plan.

Seven Key Goals and Assumptions Are Achievable or Reasonable, While Three Are Unachievable or Uncertain

We assessed 10 goals and assumptions TVA made about the future in developing the 10-year plan. Based on economic forecasts, comparisons with TVA's results of past operations, and the opinions of industry experts, we concluded that seven of the goals and assumptions were achievable or reasonable, two were unachievable, and one was uncertain. The goals and assumptions we assessed, and our conclusions about each, are summarized in table 1 and discussed in detail in the following sections.

Table 1: GAO Conclusions About the 10-Year Plan's Goals and Assumptions

Goal or assumption assessed	GAO conclusion
Future market price of power	Reasonable
Increase in demand for power	Reasonable
Increase in fuel costs	Reasonable
Supply chain savings	Achievable
Labor force reductions	Reasonable
Debt reduction and recovery of deferred assets	Unachievable
Capital expenditure limitation	Unachievable
Cost improvement initiatives	Achievable
Increased revenues	Uncertain
Customer relations improvements	Achievable

²⁰TVA officials have indicated that they will seek to identify and implement operating efficiency measures that are expected to reduce the costs associated with nonpower programs without affecting program operations.

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**Assumption About the
Future Market Price of
Power Is Reasonable**

TVA's assumption about the future market price of wholesale power is important to the success of the plan because it establishes a target that TVA must achieve in order to offer what it considers to be competitively priced power in 2007. TVA estimated that the price of wholesale power in 2007 would fall between 3.0 cents to 3.7 cents per kWh, with its best estimate being 3.4 to 3.5 cents per kWh. The Energy Information Administration (EIA) within the Department of Energy (DOE) estimated that the price of wholesale power in 2007 would be 3.69 cents per kWh, while Standard and Poor's DRI²¹ estimated that it would be 3.91 cents per kWh. The combined range of EIA and DRI estimates was 3.57 cents to 4.35 cents per kWh.²² Since TVA's projection of the future market price of power in the 10-year plan is lower, TVA is forced to be aggressive in pursuing its options to reduce costs and increase revenue.

TVA officials said that if they were to prepare the 10-year plan today, their projection for the market price of wholesale power in 2007 would increase to between 3.5 and 3.8 cents per kWh, due primarily to new environmental regulations. TVA officials stated that the new environmental regulations would likely drive up the market price of power and affect many utilities similarly. Any upward revision in the projected price of wholesale power in 2007 would have a positive impact on TVA's ability to achieve the objectives of the plan and would help offset some of the previously identified costs that are not currently considered in the plan—specifically, costs for the new environmental regulations.

However, the extent to which new environmental regulations affect any utility depends on the type and condition of its generating equipment, the portion of its power generated by coal, and the types of controls it chooses to meet the new environmental regulations. Although, in aggregate, the mix of generating plants among investor-owned utilities in the states that border on TVA's service territory is similar to its own, TVA and these utilities will not necessarily all be affected equally, depending on the condition of their equipment and the compliance options they choose.

²¹DRI is an economic forecasting and consulting company with expertise in the energy industry. DRI did not project the future market price of wholesale power based on the same criteria as TVA and EIA; we extrapolated an estimate from the data it provided.

²²In all cases, data from other sources is not 100 percent comparable to TVA's data because of slight differences in geographic boundaries, timing differences (for example, TVA's plan was developed in mid-1997 and we conferred with other sources in late 1998 and early 1999), and possible differences in methodologies.

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Therefore, the relative impact of the new and proposed environmental regulations on TVA, its neighboring utilities, and the market price of power is uncertain.

Assumption About the Increase in Demand for Power Is Reasonable

The 10-year plan assumes that the increase in demand for power in TVA's service region will average 2 percent per year over the plan period. While TVA's recent historical increase in demand for power has averaged over 3 percent annually, TVA officials were conservative in this regard because they do not expect this level of growth in demand to continue. We obtained other estimates of the increase in demand for power in TVA's geographic area from EIA, DRI, and ICF Kaiser Consulting Group, an organization hired by the Edison Electric Institute (EEI), an industry group for investor-owned utilities, to analyze TVA's 10-year plan.²³ Their estimates of growth in demand ranged from 1.7 percent to 2.5 percent. TVA's assumption about growth in demand for power is reasonable based on this range of estimates established by industry experts.

Assumption About the Increase in Fuel Costs Is Reasonable

The 10-year plan assumes that TVA's fuel cost, including its mix of both nuclear and coal as a fuel source, will increase 1.7 percent annually over the plan period. We obtained a cost increase estimate of 1.4 percent annually from EIA, which was based on a blended coal and nuclear fuel mix. We also obtained a cost increase estimate of 2.2 percent annually from DRI, which was based on using only coal as a fuel. Based on the range of these estimates, TVA's assumption about fuel costs is reasonable.

To control fuel costs, TVA officials stated that they competitively bid all coal contracts, use a cost model to determine which type of coal to purchase, and have reduced inventories to save carrying costs. These fuel-handling initiatives are expected to reduce fuel expense by \$1.6 million per year. In addition, TVA has expanded its by-product program²⁴ and expects revenue from this program to be over \$5 million per year. TVA's efforts to

²³Although ICF was hired to analyze TVA's 10-year plan by utilities that would likely compete with TVA in a deregulated environment and therefore lacks independence in this instance, ICF does offer specialized knowledge of TVA and surrounding areas. We did not rely exclusively on ICF for confirmation of TVA's assertions.

²⁴By-products are produced from burning coal. Under the by-product program, TVA avoids certain disposal costs and generates revenues from the sale of ash for ready-mix concrete, gypsum for wallboard, and structural landfill products.

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control these costs are positive steps toward the plan's cost reduction goals.

Goal for Supply Chain Savings Is Achievable

The 10-year plan assumes that improvements made to supply chain management will save, on average, \$50 million per year over the 10 years covered by the plan. And, by expanding its supply chain management efforts in the future, TVA officials believe that they can increase efficiency, save money, and maintain quality. For example, through contract management improvements, TVA expects to realize cost savings by consolidating its blanket purchasing contracts, reducing the number of small purchase orders, and renegotiating the terms and conditions of its purchases.

From the publication of the 10-year plan in July 1997 through September 1998, TVA had documented savings of about \$75 million, some of which represents categories of savings that should occur on a monthly basis. The balance represents savings on individual purchases and other procurement initiatives, some of which may also recur. As TVA implements additional supply chain management initiatives and applies lessons learned from industry and individual plants to other TVA functions, supply chain savings are expected to increase. For the first 6 months of fiscal year 1999, TVA documented savings of about \$37 million, or about \$6.2 million per month. Of the \$6.2 million, about \$4.9 million should recur monthly. On an annual basis, TVA's supply chain savings are therefore likely to be at least \$59 million, making this goal achievable.

Assumption About Labor Force Reductions Is Reasonable

The 10-year plan assumed that TVA would reduce its labor costs by reducing its labor force size from 14,960 at June 30, 1997, to 14,275 by September 30, 1997. Although TVA did not achieve this staffing level by September 30, 1997, it had reduced staff to 14,194 by December 31, 1997, and to 13,818 by September 30, 1998. Since TVA has exceeded its labor force reduction goal, the corresponding cost savings will be greater than originally anticipated.

In addition, TVA has taken or planned a number of other actions that will further help reduce labor costs, including

- negotiating compensation levels with one of its large unions, which TVA expects will help to curtail the rise in future labor costs,

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- replacing higher paid employees with lower paid employees as its aging workforce retires, and
- implementing a "shared services" concept, which involves consolidating similar operations and reducing duplicative efforts.

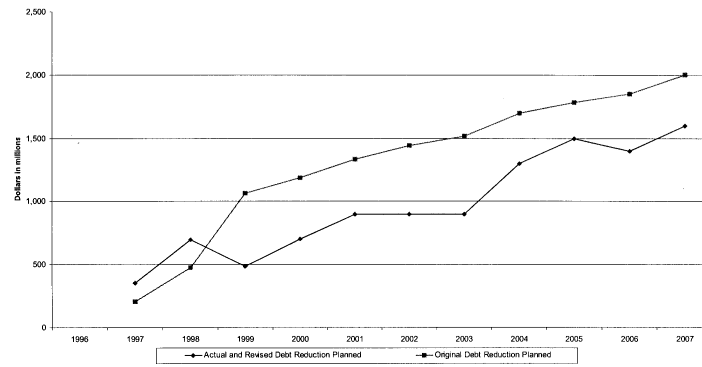
Although TVA did not quantify the dollar savings it expects through its labor initiatives, TVA's current efforts in this area should help it reduce costs.

**Debt Reduction and
Deferred Assets Recovery
Goals Are Unachievable**

The 10-year plan calls for reducing debt by about one-half to about \$14 billion by 2007. This reduction, in turn, would lower TVA's annual interest costs by half—from about \$2 billion in 1997 to about \$1 billion in 2007. The additional cash that is made available as debt is paid down and interest costs are reduced can be used to further reduce debt. This interrelationship is integral to meeting the debt reduction goal. In addition to reducing interest costs by reducing debt, TVA is pursuing other interest savings by refinancing outstanding debt, as discussed later in this report.

TVA's ability to meet its strategic objective of being in a position to offer competitively priced power by 2007 depends, to a large extent, on meeting its debt reduction goal. The plan calls for the cash flow needed to achieve this debt reduction to be provided by a combination of planned revenue enhancements, cost savings initiatives, and capital expenditure limitations. However, as discussed previously, the plan excluded additional capital costs related to investing in new generating capacity to meet growth in demand for power, complying with new environmental regulations, and funding nonpower programs that were previously funded through appropriations. As shown in figure 1, TVA exceeded its debt reduction goals for the first 2 years of the plan but does not expect to meet its original estimates for the remaining years due to the additional capital expenditures for new generating capacity and environmental regulations discussed previously.

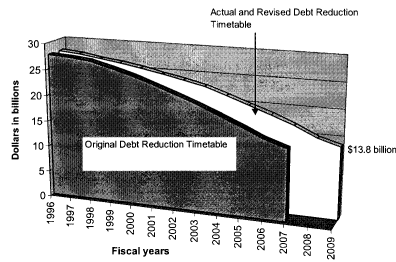
Figure 1: Comparison of Planned to Actual and Revised Annual Debt Reduction Plan



Source: GAO analysis based on data from TVA.

As a result of changes in certain of its cost estimates, TVA now does not expect to reduce debt by one-half until fiscal year 2009, about 2 years after the plan's original target date. This revised goal is reflected in TVA's fiscal year 2000 federal budget request. TVA's original and revised debt reduction timetable is shown in figure 2.

Figure 2: Original and Revised Debt Reduction Timetable



Source: GAO analysis based on data from TVA.

TVA's planned revenue enhancements and cost savings were also intended to provide TVA with the opportunity to recover a portion of the cost of its deferred assets. As noted previously, TVA expects to recover all but about \$500 million—its estimated net realizable value—of the deferred assets. However, TVA's ability to include the costs of these assets in its rates without further rate increases is directly related to its ability to meet the plan's revenue and cost savings targets. To the extent TVA does not recover the cost of its deferred assets while it is legislatively protected from competition, competitive pressures could prevent it from selling power at rates sufficient to recover the cost of these assets indefinitely.

**Capital Expenditure
Limitation Goal Is
Unachievable**

The plan assumes that capital expenditures will be limited to about \$600 million per year and excludes any capital costs for increasing generating capacity and complying with new environmental regulations. However, as discussed previously, known environmental costs alone are an estimated \$500 million to \$600 million. In addition, costs for complying with a proposed environmental regulation that is likely to be implemented within the plan period could amount to another \$450 million to

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\$500 million, some of which would be incurred before 2007. Also, the costs for meeting growth in demand for power with additional generating capacity, which are not fully estimable at this time, could further increase TVA's required capital expenditures within the period covered by the 10-year plan.²⁵ Even though upward revisions in TVA's projected market price of wholesale power could offset some of these additional costs, TVA is likely to exceed its annual \$600 million planned capital expenditures limit, thus making this goal unachievable.

Cost Improvement Initiatives Goal Is Achievable

The 10-year plan calls for TVA to undertake cost improvement initiatives that are assumed to save about \$200 million a year over the life of the plan. These initiatives include refinancing TVA's Federal Financing Bank (FFB) debt, refinancing and replacing other debt at lower interest rates, changing retirement benefits, and improving business processes. Overall, the goals related to these initiatives are achievable.

Reducing Interest Costs by Refinancing Debt

To achieve a large portion of the \$200 million annual cost improvement initiatives, the plan called for TVA to obtain authority from the Congress to prepay, without penalty, the \$3.2 billion that TVA then owed FFB, then to refinance that debt at lower interest rates. TVA received that authority in the fiscal year 1999 Treasury and General Government Appropriations Act. TVA refinanced the FFB debt with \$2.7 billion of long-term bonds having an average interest rate of 5.37 percent compared to the original 9.67 percent FFB debt, plus \$469 million of short-term debt which, as of April 1999, had a current interest rate of about 4.8 percent. Based on the actual interest rates of the refinanced FFB debt, we estimate that the interest savings will total about \$1 billion through 2007, providing an average annual savings of about \$116 million toward the \$200 million plan goal.

In addition to reducing interest by refinancing the FFB debt, the plan calls for reducing annual interest costs by refinancing a portion of the \$24 billion in outstanding publicly held debt and replacing maturing debt, as needed, with lower interest rate borrowings. Since the plan was issued, TVA has refinanced about \$6 billion of long-term public bonds that had an average interest rate of 6.96 percent with long-term bonds having an average interest rate of 6.00 percent and \$699 million of short-term borrowings that had about a 4.8 percent interest rate as of April 1999. We estimate that

²⁵As previously discussed, TVA believes any capital investments for generating capacity will lower its cost of power relative to the estimate contained in the plan.

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these actions will save an average of \$44 million in annual interest expense through 2007.

TVA may have further opportunities to refinance additional long-term public bonds at favorable rates since as of April 1, 1999, about \$11 billion of TVA's outstanding long-term public debt had interest rates higher than TVA's estimated 6.55 percent borrowing rate.²⁶ Of the \$11 billion, \$6.3 billion is callable during the plan period; however, none was callable as of April 1, 1999.

Retirement Plan Changes

According to TVA officials, another \$20 million to \$25 million a year will be saved by changes made to TVA's retirement plan. The costs of certain retiree health benefits that TVA was paying for from operations were discontinued, while at the same time a supplemental pension benefit was added to the retirement plan. The result, according to TVA officials, was a net cash flow saving of about \$20 million to \$25 million per year. According to TVA officials and as confirmed by TVA's fiscal year 1998 audited financial statements, the pension plan is currently overfunded because it has an excess of plan assets over projected benefit obligations of \$323 million as of September 30, 1998. TVA does not expect to have to make any additional contributions to the pension plan through 2007.

Business Process Improvement Initiatives

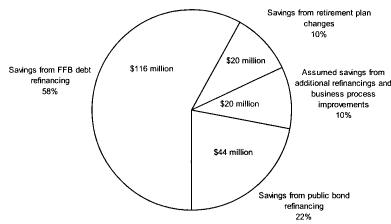
TVA also expects to achieve cost savings from business process improvement initiatives that involve bringing teams of TVA staff together to evaluate how TVA does business. For example, TVA has established teams from throughout the organization to (1) improve the technology used to process information, (2) benchmark best practices of industry as well as individual TVA plants, and (3) adopt identified best practices across the organization. While some teams appear to be well established, others are only getting started. Because these initiatives are in the early stages, their benefits have not yet been quantified, and TVA officials told us that they are only now beginning to identify cost saving techniques that can be shared throughout the organization.

As shown in figure 3, TVA substantially achieved the \$200 million cost savings goal for fiscal year 1999 by reducing interest costs and changing its retirement plan. Assuming that TVA's annual savings from refinancing debt and changing its retirement plan average \$160 million and \$20 million,

²⁶This rate represents an average rate estimated to be available to TVA for callable and noncallable long-term public bonds.

respectively, TVA must save an additional \$20 million annually by improving business processes, refinancing additional debt, and reducing other costs to achieve the \$200 million savings assumed in the plan. Since this required additional savings of \$20 million is relatively small—less than half of 1 percent of TVA's fiscal year 1998 operating revenues of \$6.7 billion—we believe that it is feasible that these changes will enable TVA to save the additional amount needed to achieve the \$200 million annual cost reduction goal.

Figure 3: Cost Savings for Fiscal Year 1999 Under TVA's Cost Improvement Initiatives



Source: GAO analysis based on data from TVA.

Assumption About Increased Revenues Is Uncertain

TVA's revenues increased significantly in fiscal year 1998 due to a rate increase and to increased energy sales. TVA's fiscal year 1998 revenues totaled about \$6.7 billion, compared to \$5.9 billion in fiscal year 1997—an increase of about \$800 million. According to TVA, about \$350 million of the increase is attributed to the rate increase; the balance is attributable to increased sales volume that resulted from extreme weather in the summer months and other factors.

The 10-year plan assumes that this rate increase is sustainable and will generate additional revenues of about \$325 million annually through 2007.

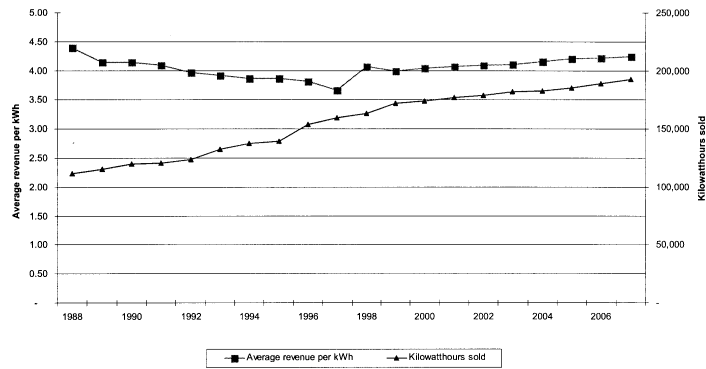
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However, based on the decline in TVA's average revenue per kWh over the past 10 years, and expectations of increasing competition in the electricity industry, we agree with some industry experts who question TVA's ability to meet the plan's assumption about future revenue. Specifically, an analyst from the Congressional Budget Office (CBO) with expertise in issues related to TVA and consultants from ICF Kaiser (which was hired by the Edison Electric Institute to analyze TVA's 10-year plan) questioned TVA's ability to meet its future revenue projections given the decline in its average revenue per kWh over the last several years.

As shown in figure 4, from 1988 through 1997, TVA's average revenues per kWh declined steadily, despite a steady increase in the amount of kilowatthours of energy sold. This decline in average revenues per kWh was attributable to credits given to large industrial customers. The actual decline in average revenues per kWh over the past 10 years contrasts sharply with the increase projected in the 10-year plan for 1998 through 2007.

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Figure 4: Comparison of Average Revenue per kWh to Kilowatthours Sold



Source: GAO analysis based on data from TVA.

In order to offer competitive rates to its industrial customers, TVA offers price breaks to its larger industrial customers. In fact, to offset the impact of the last rate increase, TVA expanded its existing credit program to include companies with commitments to purchase firm loads of more than 1 megawatt. (Previously this credit had been limited to industrial customers with firm load commitments of more than 5 megawatts.) Although deregulation of the electric utility industry is expected to put downward pressure on rates, the 10-year plan assumes that TVA will not have to offer any additional price breaks to its large industrial customers through 2007. This assumption is questionable given that TVA has offered new credits to reduce the rates of its larger industrial customers for the past 10 years and competition in the industry is increasing.

Because deregulation of the electric utility industry is expected to continue to cause future wholesale and retail electricity prices to fall, TVA will likely

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feel pressure to continue to reduce rates. In addition, recent media coverage about competition has made many utility customers more aware of price differences among utilities and raised expectations of lower prices. All of these factors combined make it uncertain whether TVA can generate an additional \$325 million in annual revenues on a sustained basis through 2007.

Goal to Improve Customer Relations Is Achievable

TVA's management recognizes that in a competitive environment, its current customers would be free to obtain power from other utilities after giving appropriate notice. Therefore, to improve its future competitive position, TVA's management decided that it must offer contract flexibility to improve relationships with its customers—159 distributors and 64 industrial and federal concerns. The 10-year plan calls for TVA to build customer allegiance by developing contract and pricing structures that better meet its customers' needs. TVA has taken actions geared toward this goal.

For example, one new contract option allows distributors to change the length of their power contracts with TVA from a rolling²⁷ 10-year term to a rolling 5-year term, after a period of 5 years (5+5 contract). This 5+5 contract, like all of TVA's power contracts with its distributors, requires the distributor to purchase all of its electric power from TVA. TVA has also implemented a new program for its large industrial customers that permits customers with power usage of more than 1 megawatt annually to be billed under real-time pricing (RTP),²⁸ which will enable these customers to reduce their electricity costs by adjusting usage patterns. TVA has implemented the RTP program on a 3-year pilot basis. TVA expects that in the long-term, the RTP program will increase revenues by increasing the demand for power. Both the 5+5 contracts and the real-time pricing program are options that TVA developed as a result of input from customers.

Customer groups we contacted were pleased with the efforts TVA is making to provide more flexible contracts. Since these options were developed in response to customer input and the initial customer response

²⁷Rolling contracts automatically renew each year (referred to as the "evergreen" provision).

²⁸RTP reflects the actual cost differences of producing power, which vary from hour to hour. RTP allows customers to reduce costs by scheduling production to take advantage of variable prices.

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has been positive, we determined that TVA's goal to improve customer relations is achievable.

Plan Has Not Been Updated to Reflect Significant Changes

As previously discussed, since the 10-year plan was issued in July 1997, actual experience related to certain key goals and assumptions has differed from that projected in the plan, and certain expectations about the future have changed. For example, TVA officials indicated that if they were to update the 10-year plan today, they would increase their projection for the future market price of power and would include costs for new environmental regulations. However, TVA has not formally updated the plan to reflect these and other changes. Examples of actual experience that differ from expectations in the plan or goals and assumptions that have changed since the plan was developed, along with their impact on the overall plan, are shown in table 2.

Table 2: Summary of Changes and Their Impact on TVA's 10-Year Plan

Changes	Impact on plan
Purchase of 8 turbines in lieu of purchasing power	Reduce net cash flow by \$65 million through 2007, but also expected to reduce the cost of power
Environmental regulations:	
(1) Nitrogen oxide	(1) Reduce total cash flow by \$500 million to \$600 million through 2007
(2) Regional haze	(2) Reduce total cash flow by up to \$500 million through 2007 ^a
Funding nonpower programs through power revenues	Reduce total cash flow by \$400 million to \$480 million through 2007 ^b
Possible upward adjustment in the future market price of power	Reduce the amount of cost reduction and/or revenue needed to meet a market price projection
Debt not reduced as quickly as planned	Delay debt reduction goal from 2007 to 2009; Increase risk that TVA will be unable to offer competitively priced power by 2007

^aDue to uncertainty regarding the timing for compliance, not all expenditures may occur during the time frame of the plan.

^bThe estimate is based on estimated expenditures of about \$50 million to \$60 million per year. TVA officials stated that they would seek to identify and implement operating efficiency measures that are expected to reduce the costs associated with nonpower programs without affecting program operations.

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Changes in individual goals or assumptions or actual experience that differs from that projected when the plan was developed can affect the entire plan. For example, the unplanned purchase of additional generating capacity results in a decrease in projected cash flow through 2007. This affects the availability of cash to pay down debt, which further impacts interest costs. Funding nonpower programs through power revenues has the same effect. The result of these and other unplanned expenditures, such as for new environmental regulations, is that TVA's time frame to meet its debt reduction goal has been extended from 2007 to 2009. In contrast, any upward change in TVA's assumption for the future market price of power increases TVA's target price for power in 2007. This means that TVA could reduce the level of cost reduction and/or revenue enhancement planned through 2007 and still be in a position to offer competitively priced power at that time.

TVA officials told us that they have internally analyzed the combined impact of an upward revision in the projected market price of wholesale power in 2007 and lower-than-planned debt reduction on TVA's ultimate objective, which is to be in a position to offer competitively priced power in 2007. While TVA officials acknowledge that they will not meet the debt reduction goal by 2007, they believe, based on their internal analyses, that TVA will still be in a position to offer competitively priced power in 2007. However, these analyses have not been formalized, nor have the results been communicated to users of the plan.

Although TVA views the plan as a living document and recognizes that projections in the plan will change over time, there is no formal mechanism for communicating changes to those who use the plan. In addition, there is no mechanism available to plan users to gauge TVA's progress toward achieving the plan's goals and objectives. Therefore, while variances in results, changes in goals and assumptions, and progress toward plan objectives may be known to TVA, they are generally not known by the plan's users. These users include public policymakers considering legislation that might impact TVA's future, analysts and investors who use information in the plan when assessing the desirability of TVA's debt offerings, and customers who are considering alternative sources of electricity in the future. As a result, those who rely on the plan to make investment and policy decisions cannot fully assess the impact of the variances and changes in assumptions on TVA's ability to meet its strategic objectives as set forth in the plan.

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The legislation proposed by the administration to promote retail competition in the electric power industry, which was discussed previously in this report, would require that TVA annually report several types of information to the Congress. If enacted, the legislation would require that TVA annually report, among other things, its progress toward its goal of competitively priced power, its prospects for meeting the objectives of the 10-year plan, any changes in assumptions that may have a material effect on its long-range financial plans, the amount by which its debt has been reduced, and the projected amount by which its debt will be reduced. This type of reporting to the Congress would help provide the information needed to monitor TVA's readiness for a competitive environment.

Conclusions

TVA management recognizes the need for TVA to be positioned to compete with other utilities in a changing marketplace. The 10-year plan is moving TVA in the right direction by addressing the most important issues facing TVA: its high fixed financing costs and limited financial flexibility and the large amount of deferred assets that TVA has not recovered through rates. The more progress TVA makes in addressing these issues while it maintains its legislative protections, the greater its prospects for being competitive if it loses these protections in the future.

Because TVA's actual experience and assumptions about the future market price of power, capital expenditures, and planned debt reduction have varied in significant ways from those envisioned in the 10-year plan, it is unlikely that TVA will generate sufficient cash flow to reduce debt and the corresponding fixed interest costs to the extent stated in the plan through 2007. This will impact TVA's ability to recover the cost of its deferred assets to the extent planned. TVA has acknowledged that its debt reduction goal will not be achieved until at least 2009. To the extent it does not sufficiently reduce debt and related fixed costs and increase financial flexibility during the 10-year period, TVA's ultimate strategic objective—to be able to offer competitively priced power by the end of 2007—could be jeopardized, depending on market conditions at the time.

However, since no one knows what the market price of power will be in 2007, it is uncertain whether TVA will be in a position to offer competitively priced power at that time. TVA could fall short of its objectives and still be competitive if its cost of producing power is at or below market. Conversely, TVA could achieve all of its objectives and not be competitive if its cost of producing power is higher than market.

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Because of changing electricity markets and other economic conditions, it is essential that TVA continuously update the plan and communicate the results of these updates, as well as TVA's progress toward its goals and objectives, periodically and formally to the Congress as it considers TVA's future in a deregulating electricity industry and to other users who have a vested interest in TVA.

Recommendations

We recommend that the Chairman of the Board of Directors of the Tennessee Valley Authority move quickly to improve the reporting of information to the plan's users. Specifically, we recommend that the Chairman ensure that TVA take the following actions:

- Revise and reissue the plan to reflect evolving conditions and operating plans and their impact on TVA's ability to meet the strategic objectives outlined in the plan by 2007. TVA should also include a discussion of its plans to recover the costs of its deferred assets. As further significant changes occur, the plan should be updated to communicate these changes to plan users.
- Periodically communicate its progress toward achieving the 10-year plan's strategic objectives to those who rely on the information contained in the plan. One option would be for TVA to expand its discussion of the 10-year plan in its annual reports, including reporting
 - how actual results compare to all of the plan's key goals and assumptions, including those for revenues, debt reduction, capital expenditures, cost savings, and the market price of power;
 - progress toward achieving performance measures related to the plan, when developed; and
 - an overall assessment of whether TVA is on course to provide competitive power in 2007.

Agency Comments and Our Evaluation

In oral and written comments on a draft of this report, TVA generally agreed with the report's contents. TVA also provided us with technical comments, which we have incorporated as appropriate. TVA's written comments are reproduced in appendix II and discussed below.

TVA commented that the market price of power is the most significant uncertainty in achieving its goal to be in a competitive pricing position as the industry is deregulated. TVA also stated that the target cost of power in the 10-year plan is aggressive and that it has not yet altered its estimate of

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the future market price of power, even though there are indications of upward movement in market price forecasts. Our report noted that TVA's target for the cost of its power in the 10-year plan is lower than projections by other knowledgeable sources and therefore forces TVA to be aggressive in pursuing its options to reduce costs and increase revenue. During the course of our review, TVA officials told us that if they were to formally update the 10-year plan, they would increase their projection of the future market price of power. As we note in our report, TVA has not formally updated the 10-year plan, even though certain expectations about the future have changed and actual experience related to key goals and assumptions has differed from projections in the plan.

TVA stated that while it will likely incur the costs of funding traditional river management programs that have historically been funded largely through appropriations, the Congress has also enacted legislation allowing TVA to refinance its FFB debt for a savings of over \$100 million a year. While we agree with both of these statements, the anticipated savings from refinancing the FFB debt were included in the 10-year plan, but the additional cost of funding traditional river management programs was not. Therefore, for purposes of gauging progress toward achievement of the plan's goals, the planned savings cannot be assumed to offset these unplanned expenditures. Our report separately discusses each of these points.

TVA noted that although its decision to purchase additional generating capacity for periods of peak demand rather than purchasing power from other utilities will adversely impact its ability to reduce debt to the extent planned, it will also help TVA achieve a lower cost of power and improve system reliability. Our report acknowledges these points and states that the decision will impact TVA's ability to reduce debt, but that TVA believes the decision will reduce the cost of its power and remove the uncertainty of having to rely on another utility for power.

With regard to our recommendations, TVA stated that its planning process is being refined and will improve over time and that TVA has committed to update the 10-year plan as material changes occur so that stakeholders will know how TVA is doing in comparison to the plan. As we noted in our report, TVA has made significant changes in assumptions and its actual experience has differed from projections since the plan was issued in July 1997, but TVA has not formally updated the plan to reflect these changes. Therefore, it is important that TVA move quickly to improve the reporting

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Abbreviations

CBO	Congressional Budget Office
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
DOE	Department of Energy
EI	Edison Electric Institute
EIA	Energy Information Administration
EPA	Environmental Protection Agency
EPAct	Energy Policy Act of 1992
FFB	Federal Financing Bank
kWh	kilowatthour
NRC	Nuclear Regulatory Commission
OMB	Office of Management and Budget
RCRA	Resource Conservation and Recovery Act
RTP	real-time pricing
TVA	Tennessee Valley Authority

Objectives, Scope, and Methodology

We were asked to determine whether the goals and assumptions in TVA's 10-year plan are achievable or reasonable in light of TVA's strategic objectives to (1) reduce the cost of power to a competitive level, (2) increase financial flexibility by reducing fixed costs, and (3) build customer allegiance. Specifically, we were asked to determine whether the 10-year plan (1) addresses key issues facing TVA, (2) takes into consideration all applicable costs and revenue sources, (3) contains assumptions that are reasonable and in line with industry estimates and expectations, and (4) has been updated to reflect significant changes in key assumptions or actual experience that differs from TVA's expectations when the plan was developed. In addition, you asked us, based on our analysis of the plan, to conclude whether TVA is likely to achieve the plan's strategic objectives.

TVA's plan consists of three strategic objectives, with goals and assumptions designed to help accomplish the strategic objectives. We evaluated the achievability and reasonableness¹ of 10 of the goals and assumptions and their impact on TVA's ability to accomplish its 3 objectives. Specifically, we assessed the achievability and reasonableness of the following goals and assumptions:

- the future market price of wholesale power will be 3.4 to 3.5 cents per kWh by 2007;
- annual growth in demand through 2007 will average 2 percent;
- fuel costs will increase 1.7 percent annually through 2007;
- improvements in supply chain management will save \$50 million annually;
- TVA's labor force will be reduced, and additional costs savings will be achieved through the creation of shared services and other initiatives;
- debt will be reduced by about one-half to about \$14 billion, and the balance of deferred assets will be reduced from \$8.5 billion to \$500 million—TVA's estimated net realizable value of these assets;
- capital expenditures will be limited to about \$600 million annually and increases in demand through 2007 will be met primarily through purchased power;
- \$200 million will be saved annually through cost improvement initiatives primarily related to refinancing Federal Financing Bank (FFB) and

¹We assessed the achievability of the 5 goals and the reasonableness of the 5 assumptions contained in TVA's 10-year plan.

Appendix I
Objectives, Scope, and Methodology

public bond debt, pursuing changes to its retirement plan, and improving business processes;

- revenues from power sales will be increased by about \$325 million annually by implementing a rate increase in 1998 and maintaining it through 2007; and
- customer relations will improve through new contract and pricing options.

As agreed with your offices, we did not (1) assess whether achieving the objectives of the plan would ensure TVA's future competitiveness or (2) develop independent estimates of key elements of the plan, such as the future market price of power. Instead, we relied on comparisons of past performance to future projections, the opinions of industry experts, and economic forecasts made by knowledgeable sources to determine whether the individual components of the plan and the plan as a whole were achievable and reasonable.

Assessing Whether the Plan Addressed Key Issues Confronting TVA

To determine whether the three objectives of the 10-year plan addressed key issues confronting TVA as it seeks to increase its prospects for being competitive in the future, we (1) examined the actions that were being taken by other utilities to prepare for competition and compared them to TVA's plan, (2) reviewed prior GAO reports on issues confronting TVA, (3) interviewed TVA officials, (4) reviewed TVA's annual reports for 1997 and 1998, (5) spoke with officials from the Congressional Budget Office (CBO) and Office of Management and Budget (OMB) with expertise in issues pertaining to TVA, (6) interviewed industry representatives from TVA's customer groups, and (7) interviewed representatives from both the public power and investor-owned segments of the industry familiar with TVA and its service area.

Assessing Whether Appropriate Costs and Revenues Were Considered

To determine whether the 10-year plan considered appropriate costs and revenue sources, we (1) reviewed prior GAO reports on TVA, (2) interviewed TVA officials, (3) reviewed other electric utilities' annual reports and audited financial statements to determine the types of costs they were reporting, (4) reviewed TVA fiscal years' 1997 and 1998 annual reports and audited financial statements to determine the types of costs and revenues TVA had reported, (5) analyzed comparative historical and forecast operating statement percentages calculated from TVA financial model information underlying the 10-year plan, (6) spoke with an official from the Environmental Protection Agency (EPA) regarding environmental

costs under new regulations and TVA's status as a potentially responsible party under CERCLA and RCRA, (7) interviewed industry experts familiar with TVA and its service area, (8) spoke with an official from the Nuclear Regulatory Commission (NRC) on the adequacy of TVA's nuclear decommissioning fund, (9) determined that TVA's external financial statements auditor was satisfied with TVA's nuclear decommissioning obligations and trust fund assets as part of its fiscal year 1998 audit, and (10) inquired about costs related to TVA's plans to comply with Year 2000 computer issues. However, we did not assess TVA's readiness to deal with Year 2000 computer issues.

Assessing Whether the Plan's Goals and Assumptions Were Achievable or Reasonable

To determine whether goals and assumptions were achievable or reasonable and in line with industry estimates and expectations, we (1) interviewed TVA officials, (2) compared past results of TVA's operations to projections in the plan, and (3) spoke with officials from (a) the Energy Information Administration (EIA), the statistical agency within DOE, (b) Standard and Poor's DRI, an economic forecasting and consulting company with expertise in the energy industry, (c) EPA, (d) CBO, (e) NRC, (f) groups of TVA customers, including both distributors and direct-served customers, and (g) industry groups representing both the public power and investor-owned utility segments of the industry.

For each goal or assumption, we compared TVA's projections with those of the appropriate agencies and with TVA's historical results. Specifically, to determine whether each goal or assumption was achievable or reasonable, we did the following work:

- **Future market price of wholesale power:** We interviewed TVA officials and spoke with EIA, DRI, and industry experts familiar with TVA and its service area. We then compared TVA's projections with those of these other entities.
- **Annual growth in demand:** We reviewed TVA's past annual growth history and interviewed TVA, CBO, DRI, and EIA officials and industry experts familiar with TVA and its service area. We also relied on previous GAO work on TVA's demand growth methodology done in 1995; we did not reassess this methodology because our comparison of TVA's projections with past results and the projections of DRI and EIA gave us no reason to believe that any changes TVA may have made in its methodology would have caused a significant difference. Based on the results of our review, we determined the reasonableness of TVA's assumptions.

- **Increase in fuel costs:** We reviewed TVA's annual fuel costs for prior years, interviewed TVA officials, and spoke with officials from DRI and EIA. We then compared TVA's projections to those of these other entities to determine reasonableness.
- **Improvements in supply chain management:** We interviewed TVA officials and examined documentation on (1) changes in procurement policies and procedures, including the use of blanket contracts versus individual purchase orders, (2) savings achieved since 1997, both recurring and nonrecurring, and (3) plans to phase in additional cost savings programs. We then analyzed whether these changes would be likely to enable TVA to achieve and sustain the level of savings projected in the 10-year plan.
- **Reduced labor force:** We interviewed TVA officials, reviewed the decrease in personnel over the last 10 years, and analyzed whether TVA's assumptions seemed reasonable.
- **Reduced debt and related interest costs and recovery of deferred assets:** We interviewed TVA officials, analyzed information in the President's fiscal year 2000 budget, contacted Moody's Investors Service in regard to the effect of bond ratings on interest rates, and analyzed and verified the plan's supporting documentation by tracing it to TVA's audited financial statements. In addition, to determine whether TVA's plan to recover through rates the costs of deferred assets was achievable, we interviewed TVA officials, spoke with a CBO official about the impact of planned revenues on the availability of income to recover the costs of these assets, and analyzed supporting schedules provided to us by TVA. We also spoke with TVA officials about its plans for the Bellefonte nuclear plant, which comprises the bulk of TVA's deferred nuclear generating units.
- **Capital expenditures:** We interviewed TVA officials, a CBO analyst, and industry experts. Additionally, for each of the two capital expenditure issues, we performed additional procedures. Specifically:
 - for capital expenditures for new capacity and upgrades to existing capacity, we compared TVA's historical capital expenditures to its planned expenditures and analyzed whether the plan's goal of meeting future growth in demand by purchasing power from other utilities was achievable and
 - for expenditures related to new environmental regulations, we obtained data from EPA and EIA on projected costs under new and proposed environmental regulations. We then compared TVA's projections with those of EPA and EIA to determine the achievability of TVA's goals.

- **Cost improvement initiatives:** We interviewed TVA officials, examined documentation relating to TVA's business process improvement efforts, reviewed information in TVA's annual report on its pension fund, analyzed the impact of TVA's refinancing efforts to date, obtained projected interest rates through 2007 from EIA, and compared the plan's projections to TVA's actual portfolio interest rates and EIA's projections.
- **Projected revenues:** We interviewed TVA officials, reviewed TVA's revenue experience over the past 10 years, analyzed the correlation between kWhs sold and revenue, spoke to TVA's customer groups about their expectations for TVA's price of power, and interviewed CBO and industry representatives about the reasonableness of TVA's revenue projections.
- **Improved customer relations:** We interviewed TVA officials, representatives of TVA's customer groups, and industry representatives from both the public power and investor-owned segments of the market.

**Assessing Whether the Plan
 Had Been Updated for
 Significant Changes**

To determine whether TVA had updated the plan for significant changes, we (1) determined whether significant changes had occurred based on the procedures described above, (2) examined the process whereby TVA internally updates its projections, and (3) interviewed TVA officials about whether they had updated the plan internally or externally and/or had any plans to do so.

**Assessing Whether Strategic
 Objectives Are Achievable**

After we determined the achievability or reasonableness of each of the underlying goals and assumptions of the plan, we assessed the plan in its entirety to determine whether all of these separate elements added up to a cohesive, reasonable plan that should enable TVA to achieve its three strategic objectives. For the two interrelated strategic objectives—reducing the total delivered cost of power and increasing financial flexibility by reducing fixed costs—we analyzed whether achieving the goals of the plan was possible and whether achieving the goals would necessarily help TVA achieve the strategic objectives. For the third strategic objective, building customer allegiance, we analyzed the results of our discussions with both TVA's customer groups as well as industry representatives from both the public power and investor-owned segments of the market.

We conducted our review from June 1998 through April 1999 in accordance with generally accepted government auditing standards.

Appendix I
Objectives, Scope, and Methodology

**Organizations
Contacted**

During the course of our work, we contacted the following organizations.

Federal Agencies

- Congressional Budget Office
- Department of Energy's Energy Information Administration
- Environmental Protection Agency
- Nuclear Regulatory Commission
- Office of Management and Budget
- Tennessee Valley Authority

Bond Rating Agency

- Moody's Investors Service, New York, New York

**Customer Representative or
Trade Groups**

- American Public Power Association, Washington, D.C.
- Tennessee Municipal Electric Power Association, Brentwood, Tennessee
- Tennessee Valley Industrial Committee/Associated Valley Industries, Columbia, Tennessee
- Tennessee Valley Public Power Association, Chattanooga, Tennessee

Consulting Firms

- Gas Research Institute, Chicago, Illinois
- ICF Kaiser Consulting Group, Fairfax, Virginia
- Standard and Poor's DRI, Lexington, Massachusetts

Others

- Federal Accounting Standards Advisory Board
- Edison Electric Institute's TVA Watch Group, Washington, D.C.
- McMinnville Electric System, McMinnville, Tennessee

Appendix II

Comments From the Tennessee Valley Authority

Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1499

David N. Smith
Chief Financial Officer and Executive Vice President
Financial Services

April 23, 1999

Ms. Linda Calbom
Director, Resources, Community and Economic Development,
Accounting and Financial Management Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. Calbom:

Thank you for the opportunity to provide comments on the GAO's draft report on TVA's Ten-Year Business Plan, published in July 1997.

As your report noted, the primary objective of TVA's 10-year plan is to ensure that TVA retains its competitive pricing position as the industry is deregulated. Of course, the future market price of power is the most significant uncertainty in achieving that goal.

As the report states, TVA projected an aggressive target of 3.4 to 3.5 cents per kWh for the price of power in 2007—which is about 15% below TVA's already competitive average price. Even though there are indications of upward movement in market price forecasts—supported by projections cited in the report between 3.57 and 4.35 cents per kWh—TVA has not yet altered its estimate.

The report points out that since TVA's plan was published, it has become likely that TVA will incur the cost of funding traditional river management programs that have been largely funded in the past from Congressional appropriations. Appropriations for these essential stewardship functions were \$50 million for FY 1999. But, as you know, Congress enacted legislation since the issuance of the plan allowing TVA to refinance its Federal Financing Bank debt for a savings of over \$100 million per year.

The report also expressed concern that our recent decision to build additional peaking capacity, rather than purchase power on the market, would impact TVA's ability to reduce its debt to the extent planned. While this is true, TVA's plan expected that there would be economic choices to make along the way which could require additional capital investment to achieve a lower cost of power or to increase system reliability. Our recent decision to add certain amounts of peaking capacity was one such example.

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Appendix II
Comments From the Tennessee Valley
Authority

Ms. Linda Calborn
Page 2
April 23, 1999

TVA management developed its 10-year Business Plan using the best information available in July 1997, and we remain committed to the fundamental objective of the plan—to be in a position to deliver competitively-priced power to TVA's customers in the year 2007. As actual events unfold and planning assumptions evolve, TVA will adjust its plan accordingly, but without losing focus on the primary objective of the plan—to ensure that our prices remain competitive in a deregulated future. All of TVA's organizational units are fully engaged in further refining the plan, and through this continuous process our planning capability will, in itself, improve over time.

TVA has various stakeholders—including customers, investors, the Congress, and the Administration—who are interested in and have the right to know how TVA is doing against its plan. We have in fact had many discussions with members of all these groups since the plan was published, and have committed to them that we will update the plan as material changes occur. Although there have been new developments since July 1997—some positive and some negative—we believe that, overall, TVA is still on track toward meeting the objectives of the plan.

Thank you again for the opportunity to provide these comments.

Sincerely,



David N. Smith

Appendix III

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GAO

United States General Accounting Office

Report to the Chairman, Committee on
Governmental Affairs, U.S. Senate

September 1999

TENNESSEE VALLEY AUTHORITY

Facts Surrounding Allegations Raised Against the Chairman and the IG



GAO

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GAO/OSI-99-20



United States General Accounting Office
Washington, D.C. 20548

Office of Special Investigations

B-283001

September 15, 1999

The Honorable Fred Thompson
Chairman, Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

The Tennessee Valley Authority (TVA), a wholly owned government corporation, is responsible for developing and conserving the natural resources of the Tennessee River Valley and supplying power throughout a seven-state area, presently through 159 distributors, or customers. TVA is governed by a three-member Board of Directors appointed by the President and confirmed by the Senate for a 9-year term. Chairman Craven Crowell is currently the sole member of the Board because Director Johnny H. Hayes resigned on February 1, 1999, and Director William Kennoy's term expired on May 18, 1999.

The current Inspector General (IG), George Prosser, began his tenure in April 1994. As 1 of 33 statutory offices initially established by Congress under the Inspector General Act Amendments of 1988,¹ he was appointed by TVA's Board of Directors. The act gives the agency head, in this case the TVA Board, general supervisory authority over the IG but provides that the agency head cannot interfere with the audit and investigative functions of the Office of Inspector General (OIG). The 1988 amendments also provide that only federal audit entities, including GAO and other IGs, may perform a review to determine whether an IG has internal quality controls and is complying with audit standards established by the Comptroller General as required by section 4(b)(1)(A) of the Inspector General Act of 1978.²

On May 26, 1999, the TVA IG issued a report (otherwise known as a 7-day letter) to the TVA Board of Directors and the Congress pursuant to

¹ Pub. L. No. 100-504, 102 Stat. 2515 (1988).

² Pub. L. No. 95-452, 92 Stat. 1101 (1978).

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section 5(d) of the Inspector General Act.³ In that report, the IG alleged that the Board Chairman, the sole Board member, had "harassed him" and attempted to impede the independence of the OIG. Shortly thereafter, the Chairman of TVA, on advice of the Office of Management and Budget (OMB) and in accordance with Executive Order No. 12933, referred two matters to the Integrity Committee of the Executive Council on Integrity and Efficiency (ECIE)⁴ relating to questionable credit card charges by the IG⁵ and concerns about the management of the OIG. On June 2, 1999, you requested that we assist the Committee in investigating the IG's allegation against the Chairman and the Chairman's allegation regarding the IG's credit card usage.

Results in Brief

With regard to the IG's allegation against the Chairman, we found that it was based on the disagreement between the IG and the Chairman over the Chairman's authority to both direct a broad management review of the OIG and contract with a nonfederal entity to conduct the review. The Chairman's actions as discussed below could be viewed as an attempt to undermine the independence of the IG.

Not knowing that a peer review of the OIG had been conducted only months previously, the Chairman decided to initiate a management review of the OIG based in part on two anonymous allegations. These allegations concerned the lack of performance appraisals and merit increases in the OIG and an OIG manager's abuse of time and attendance policies. When the Chairman discussed the review with the IG, the IG initially agreed to it; and

³ Section 5(d) requires IGs to report immediately to the head of their respective establishments whenever they become aware of particularly serious or flagrant problems, abuses, or deficiencies regarding the establishment's administration of programs or activities. Within 7 days of receipt of the report, the head of the establishment is required to send the report to the appropriate congressional committees or subcommittees along with a report containing appropriate comments. (Inspector General Act of 1978, as amended, 5 U.S.C. App. 3, § 5(d) (1994))

⁴ ECIE consists of statutory IGs appointed by the heads of designated federal entities. As a result of Executive Order No. 12805, which was signed in 1992, ECIE became a member of the President's Council on Integrity and Efficiency (PCIE). PCIE is an interagency council that is charged with promoting integrity and effectiveness in federal programs. The PCIE is chaired by the Deputy Director for Management at the Office of Management and Budget.

⁵ As a member of TVA's senior management, the IG was authorized to use a TVA Visa Gold Card for hospitality expenses including, but not limited to, meals, refreshments, and entertainment. TVA pays for these expenses.

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TVA contracted with a nonfederal entity to conduct the review. However, when the IG was presented with an OIG legal counsel opinion and after discussions with other IGs and members of Congress, he became concerned about the appropriateness of such a review and informed the Chairman of his reversal of opinion. The Chairman later decided to use another OIG to conduct the review and believed that the IG would accept such an arrangement. The Chairman was unaware that this offer was not communicated to the IG as he had directed. However, before it was determined that the IG had not been informed about the Chairman's decision, TVA's Chief Administrative Officer (CAO) initiated a separate review of the IG's use of his TVA credit card during his 5-year tenure (1994-1999). To our knowledge, the proposed management review of the OIG has been suspended.

As a result of his separate conversations with the Chairman and the CAO, the IG felt that the Chairman was threatening the OIG's ability to conduct investigations and wanted to remove him from office. One reason the IG provided for feeling threatened was his May 25, 1999, conversation with the CAO regarding the Chairman's reaction to the May 14, 1999, acquittal of TVA's former Chief Operating Officer on criminal charges. Thus, the IG sent the 7-day letter to the Chairman. To counter his belief that the IG would release the 7-day letter to the press, the Chairman released to the press his recent letter to a member of Congress. In that letter, the Chairman alleged that the IG had abused his use of the TVA-issued credit card. Subsequently, the Chairman referred the following allegations to the ECIE for its consideration: the previously mentioned OIG mismanagement, the IG's lack of independence, and the IG's misuse of his TVA credit card. This referral was based on the two anonymous allegations and a cursory review of the IG's credit card charges. However, the OIG had reviewed the management issues that the Chairman referred to the ECIE and had taken action on them prior to the referral. Details of the initial TVA allegations along with additional allegations were leaked or released to the media. Then on August 20, 1999, the Chairman placed the IG on paid leave pending resolution of the allegations referred to the ECIE.

When the Chairman initiated his attempt for a management review of the OIG, all three Board positions were occupied. However, he began his most aggressive actions when his staff completed the analysis of the IG's credit card usage. By that time, the two other Board members had vacated their positions. The Chairman's actions included the release of unsubstantiated allegations to the media and the referral to ECIE.

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With regard to the Chairman's allegations concerning the IG's lack of independence, the IG recognized that his closeness to TVA management and his attendance at TVA social functions could have led observers to construe that his independence had been compromised. However, he had investigated allegations involving all three directors, including an audit of a \$30-million, irrevocable trust created and controlled by the Chairman and funded by TVA. This audit resulted in the revocation of the trust and the funds' return to TVA. Further, the audit assisted a criminal investigation by the Federal Bureau of Investigation (FBI) on this matter, which the Department of Justice declined to prosecute. In addition, we found no evidence of TVA credit card misuse by the IG for the period we analyzed in depth (Jan. 1998 through mid-May 1999). On the issue of whether the expenditures were in accord with applicable TVA policy, we determined that all of the questioned charges—including charges for hotels, restaurants, golf and liquor—had been incurred as a result of activities undertaken at Director Hayes' direction and conformed to TVA's policies.

Allegations That the Chairman Impeded the IG's Independence

Two OIG Personnel Complaints Triggered Broad-Based Management Review

On November 19, 1998, the Chairman received an anonymous allegation that the OIG had not given performance appraisals and merit increases to support staff. After receiving the allegation, the Chairman asked the General Counsel to determine whether the allegation had merit and whether the Board could award a contract for an independent review of the OIG. The General Counsel informed the Chairman that his office had recently received an anonymous allegation that an OIG branch manager had abused the OIG's time and attendance policies. He added that the allegation had been referred to the OIG because it was a management issue. When the Chairman learned of the second allegation, he requested the General Counsel to advise the Board how to handle these allegations.

By memorandum dated December 3, 1998, the General Counsel responded, advising the Chairman that the Board should not refer the anonymous allegations to the ECIE because they raised management issues rather than the type of "wrongdoing" set forth in Executive Order No. 12933 that warranted referral. However, he opined that the Board could seek an

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outside review by a contractor to determine whether the OIG was functioning properly. The General Counsel added that the Board had hired an outside contractor to review the OIG in 1993⁶ during William Hinshaw's tenure as IG.

By memorandum dated December 7, 1998, the Chairman notified the Board about the two anonymous allegations he had received involving the OIG. The Chairman advised the Board that he planned to ask the CAO, a previous TVA IG, to recommend an outside firm to independently evaluate the OIG because it had been 5 years since the last review. When the other Board members did not respond to the memorandum, the Chairman concluded that they had concurred with his belief that a review of the OIG was necessary.⁷

According to the Chairman, two factors led him to believe that a review of the OIG was warranted: (1) the General Counsel had advised him that the allegation regarding the OIG's failure to provide performance appraisals was "troubling" and (2) the OIG had not been reviewed in 5 years. The CAO and General Counsel told us that the allegations against the OIG had triggered the Chairman's interest in a review of the OIG. According to the CAO, other underlying reasons might have existed. For example, the Chairman had stated that the IG spent too much time socializing with Directors Hayes and Kennoy.

On December 11, 1998, the Chairman sent his December 7 memorandum to the IG. However, the OIG had previously reviewed and acted upon the first anonymous complaint, received from the Office of General Counsel, concerning the alleged abuse of time and attendance. The OIG's action included informing all OIG staff of time and attendance policies and counseling the individual employee named in the allegation. Upon receipt of the memorandum containing the second allegation concerning

⁶ The Chairman requested, and the Board approved, the 1993 review of the OIG. Dempsey and Associates and TVA were the contracting parties. Under the contract, the contractor agreed to review the OIG's resources, procedures, training, and operations. The contract did not contain any provisions regarding the Board's oversight of the review.

⁷ Former Director Hayes told us that he did not raise any concerns about the review because the Chairman and the CAO had informed him that it was a routine management review aimed at helping the OIG run better. He explained that he did not respond to the memorandum because he anticipated that the Board would discuss the issue before signing the contract. Former Director Kennoy did not explain why he had not responded to the memorandum.

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performance appraisals and merit increases for support staff, the OIG reviewed each OIG employee's file to determine if performance reviews for the previous 4 years were included. This review determined that a few employees did not have all their service reviews, and the IG worked with the respective managers to obtain the missing reviews. Further, the OIG updated its human resources computer system to reflect current performance review information.

After the IG's receipt of the December 7 memorandum, the Chairman and the IG met to discuss the proposed management review. The Chairman told the IG that he had tasked the CAO to recommend an outside auditor. The IG advised the Chairman that it would be inappropriate for PriceWaterhouseCoopers to conduct the review since the firm audits TVA's financial statement, which the OIG then reviews. In addition, the IG told the Chairman that the CAO, as a former TVA IG, should not prepare the list of potential contractors from which the IG would select. The Chairman agreed with the IG that PriceWaterhouseCoopers should not conduct the review but disagreed that the CAO should not take part in identifying potential contractors.

According to the IG, he did not raise any concerns at the meeting about the review of the OIG because he knew that an outside entity had conducted the 1993 review of the OIG. He explained, however, that when he met with the Chairman, he did not know that the OIG's legal counsel had advised the previous IG that the Board lacked the authority to contract for the 1993 review of the OIG. The IG added that he has always had a good relationship with all Board members and noted that the Board never interfered with any audit or investigation he had initiated. He stated that his office had investigated a number of senior TVA officials, including all three Board members, and issued reports that were critical of TVA's administration. For example, he audited a \$30-million, irrevocable trust that the Chairman had created and controlled.⁶ This trust was funded by TVA. The results of the OIG audit assisted in the FBI's criminal investigation, which the Department of Justice declined to prosecute; the revoking of the trust; and the funds' return to TVA.

On March 3, 1999, the CAO notified the IG that he had identified PriceWaterhouseCoopers and Verner Lipfert, Bernhard, McPherson &

⁶ This audit resulted from a GAO referral to the TVA OIG of an allegation that the GAO FraudNet had received.

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Hand (Verner Liipfert) as the two potential contractors. Because of his previous objection to PriceWaterhouseCoopers as the contracting party, the IG's only option was Verner Liipfert.

IG Raised Concerns About Management Review

On March 20, 1999,⁹ the IG reviewed a copy of a 1993 memorandum from the OIG legal counsel to the then IG. In the memorandum, the legal counsel questioned whether the Inspector General Act, as amended, allowed nonfederal entities to perform reviews of OIGs.¹⁰ The OIG legal counsel told us that he provided the memorandum to the IG as soon as he remembered that he had provided advice concerning the propriety of the 1993 proposed review. On March 22, 1999, the IG met with a TVA Assistant General Counsel and advised her that he had concerns about the legality of the review based on the 1993 memorandum.

The next day, March 23, 1999, representatives from Verner Liipfert and its subcontractor Deloitte & Touche signed a contract with TVA to review the OIG. The IG had no input into any aspect of the review, including its scope, and did not know that the contract was being signed. Prior to the award of the contract, the CAO provided copies of the two anonymous allegations to the contractor, which it was to consider during the management review. Under the contract, Verner Liipfert agreed to perform a broad-based review of the audit, investigation, and inspection activities of the OIG and to prepare a report of its findings for the Chairman. Verner Liipfert's responsibilities included, among other things, reviewing (1) OIG practices and procedures, including manuals, memoranda, and correspondence; (2) fiscal management procedures, with a selective analysis of budgets and expenditures; (3) structure and organization, including the tracking of ongoing projects and follow-up after the completion of an audit or

⁹ Also on Mar. 20, 1999, TVA issued a press release announcing that the Board had ordered a review of the OIG and stating that nothing in particular had prompted the review. According to the press release, the review would look at performance efficiency and monitor the IG's operations. The IG reportedly had no objection to the review.

¹⁰ 5 U.S.C. App. 3, § 4(b)(2).

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investigation; (4) training programs; and (5) management goals, strategies, and procedures.¹¹

After the contract was signed, the Chairman asked the IG to meet with him and the contractor. At the meeting, the IG informed the Chairman that he had specific concerns that the review by a *nonfederal entity* might violate the Inspector General Act. The IG told us that the Chairman was very upset and "chewed him out" for questioning the Board's authority to hire a contractor to perform the review. As a result of the IG's objection, the contractor told the Chairman and the IG that it would not start the review until it received notice that the issue concerning the review's legality had been resolved. Subsequently, the Chairman called the IG to inform him that the General Counsel would research the matter further.

Negotiations Concerning Contract Were Unsuccessful

On March 26, 1999, the OIG legal counsel informed the General Counsel that the IG would accept Verner Lipfert as the entity to perform the review if the IG, rather than the Board, was the contracting party. The OIG legal counsel added that a representative of the President's Council on Integrity and Efficiency (PCIE) at OMB had told the IG that this arrangement was permissible.

On April 30, 1999, the General Counsel sent a memorandum to the Chairman outlining the options available to the Board for a management review of the OIG. According to the memorandum, the issue was discussed with representatives from GAO,¹² OMB, Department of Justice, and Office of Government Ethics. The General Counsel told the Chairman that the most desirable course would be for the Board to reach an agreement with the IG as to the review's necessity, the party to perform it, and the scope of the review. However, the General Counsel recommended that the contract include specific provisions pertaining to the flow of information to and from the Board and Verner Lipfert.

¹¹ In addition to these tasks, the contractor was required to determine the extent to which the OIG supported TVA's goal of being "customer-driven, employee-sensitive, environmentally responsible and growth-oriented"; examine the existing procedures for measuring performance and productivity; and examine criteria for allocating resources and establishing priorities.

¹² On Mar. 25, 1999, TVA's Office of General Counsel contacted GAO's Director of Audit Oversight and Liaison, who was responsible for GAO work on IG matters, to discuss various options available to the Board for a review of the TVA OIG.

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The Chairman agreed that the IG should be the contracting party as long as the Chairman could request the contractor to review specific matters identified during the review. At the Chairman's request, on May 5, 1999, the General Counsel provided an outline of his proposed contract modifications to the IG. In the document, the General Counsel proposed that the OIG be the contracting party. He also proposed requiring Verner Lipfert to (1) hold entrance and exit conferences with, and to provide weekly reports to, the IG and the Chairman; (2) review and fully address in the final report matters that the IG or the Chairman requested; and (3) provide copies of the final report to the IG and the Chairman.

The IG reviewed the General Counsel's proposals and obtained advice from the OIG legal counsel. On May 6, 1999, the OIG legal counsel sent the IG's counter proposals to the TVA Office of General Counsel. While the IG agreed that his office should be the contracting party, he wanted to limit the Board's involvement in the review and/or oversight of the contractor. Specifically, the IG proposed modifying the contract to state that the IG would keep the Board apprised of the status of the review and would provide a copy of the final report to the Board for its dissemination. The IG told us that although he opposed adding language to the contract regarding the Chairman's role, he agreed to allow the Chairman to have unrestricted access to the contractor.

The Chairman, however, did not agree that this later proposal should be left to an oral understanding, believing instead that the written contract should require the contractor to review the matters that he identified. The General Counsel informed the IG of this on the same day that he received the IG's proposals.

The next day, the IG told the General Counsel that he was withdrawing his offer that the OIG be the contracting party. He explained that members of Congress and the IG community had expressed strong objections to proceeding with any review that the Chairman could direct. The IG suggested that the General Counsel request an opinion from OMB regarding the Chairman's authority to oversee the contractor's actions during a review of the OIG. However, no such request was made.¹³

¹³ Although there was no document terminating the Mar. 23, 1999, contract with Verner Lipfert, officials of both TVA and Verner Lipfert informed us that it had been terminated.

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According to the IG, he concluded that the review was inappropriate in part because TVA had used an OIG management review to remove William Hinshaw, the previous IG. Both Mr. Hinshaw and former Director Kenney told us that the purpose of the prior OIG review was to remove Mr. Hinshaw as IG. However, because Mr. Hinshaw subsequently resigned from TVA, the review was discontinued before the contractor issued a final written report to the Board.

Chairman Opted to Request Federal Entity's Review of the OIG

On May 5 or 6, 1999, after negotiations between the Chairman and the IG had reached an impasse over whether the Chairman could share oversight of the review with the IG, the Chairman requested advice from the U.S. Attorney for the Eastern District of Tennessee on how to proceed. According to the Chairman, the U.S. Attorney recommended that TVA identify three other federal IGs and let the IG select one to conduct the review. The Chairman accepted this advice, instructed the CAO to prepare the list, and asked the General Counsel to tell the IG about the new proposal.

On the morning of May 14, before the list was completed, the IG called the Chairman to advise him that a federal district court jury had acquitted Joe Dickey, TVA's former Chief Operating Officer, of all criminal charges.¹⁴ The Chairman admitted to us that he had harshly criticized the IG and the OIG during the conversation because of the acquittal. The Chairman explained that he was upset because the OIG had spent approximately 2 years investigating Mr. Dickey and he believed that the acquittal might expose TVA and the IG to a civil lawsuit. During the conversation, the Chairman told the IG that he should now cooperate with the management review. The IG did not respond to this comment.

At the time, the Chairman assumed that the IG knew about his decision to allow an IG to review the TVA OIG. However, the General Counsel had not told the IG about the Chairman's decision. To our knowledge, the management review of the OIG has been suspended.

¹⁴ During an OIG audit of TVA contracts that started in Sept. 1996, issues were raised concerning a contract awarded by Mr. Dickey, TVA's Chief Operating Officer. These issues were referred to OIG Investigations in Jan. 1997. Mr. Dickey resigned from TVA on Aug. 14, 1998, and was indicted on Sept. 15, 1998. This indictment was superceded on Nov. 4, 1998. The trial ended in an acquittal of all charges on May 14, 1999.

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**TVA Initiated Review of IG's
Credit Card Use**

On the afternoon on May 14, 1999, after hearing the conversation between the Chairman and IG regarding the Dickey case, the CAO directed two senior members of his staff to obtain copies of all of the IG's TVA credit card statements from 1994 to 1999 (the entire time the IG had served as IG) and analyze them. Based on this analysis, one staff member prepared a memorandum for the CAO on May 27, 1999, questioning the propriety of the IG's golf, restaurant, and liquor charges since, in the employee's view, the IG had no obvious business reason to be so heavily involved in such activities. The staff member who prepared the memorandum admitted he had conducted only "a very brief preliminary review of charges" on the IG's credit card statements and recommended that a further detailed review be performed before any final determination was made.

According to the CAO, he requested the review because he considered the IG's use of his TVA credit card for golf fees to be inappropriate. In his view, these actions compromised the IG's independence as the IG was socializing with distributors and with managers whom he was charged with monitoring. The CAO further stated that he first learned about the IG's golf expenses when TVA was preparing a response to a January 13, 1999, request from the *Knoxville News Sentinel* for the Board members' 1998 calendar year travel, entertainment, and golf charges. He said that while the Chairman was reviewing the charges that were made by the Board members, 12 TVA executives were identified who frequently traveled, played golf, and socialized with former Director Hayes. Information regarding the 12 employees' 1998 golf credit card charges, that included the IG, was compiled on March 16, 1999, with no further action taken.

The IG learned about the review of his credit card usage in a meeting with the CAO on May 25, 1999. Based on the May 14 meeting with the Chairman, the IG asked the CAO for the meeting to discuss his options regarding his future at TVA. According to the IG, the CAO suggested that he retire and take a severance package, because the Chairman would spend every day of the next 3 years "screwing" with him. As an example of this, the CAO told the IG that TVA had reviewed his credit card statements and found he had improperly charged golf expenses. According to the IG, the CAO informed him that the Chairman had referred his golf charges to the U.S. Attorney for the Eastern District of Tennessee.¹⁵ The IG also said that the CAO

¹⁵ The IG subsequently contacted the U.S. Attorney, who denied knowing about a referral involving the IG's credit card use. We attempted to talk with the U.S. Attorney about this matter, but the Department of Justice declined our request for an interview.

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mentioned the Chairman's conversation with the U.S. Attorney regarding the identification of three IGs to conduct the review and the IG's selection of one to conduct the review. However, the IG did not interpret this as an offer for him to select an IG to conduct the review.

The CAO described the conversation somewhat differently. According to the CAO, he told the IG that the Chairman had 3 more years until his term expired, he knew that the relationship between the Chairman and IG was not good, and it was not going to improve. The CAO stated that they discussed two options: the IG could retire or stay and fight the management review. He added that the IG raised the subject of whether a severance package was available. The CAO admitted telling the IG that his credit card charges had been reviewed but denied telling the IG that the matter had been referred to the U.S. Attorney. The CAO also stated that, for informational purposes only and not as an offer to the IG, he had told the IG that the Chairman had spoken with the U.S. Attorney regarding the use of another IG to conduct the management review.

After his May 25, 1999, meeting with the CAO, the IG called a congressional member of the Tennessee Valley Authority Congressional Caucus, to inform him that the Chairman wanted the IG to retire. The IG and the Chairman told us that another member of Congress had called them shortly after the IG's conversation with the caucus member. According to the Chairman, the second member informed him that the IG had asserted at an IG conference in April that the proposed review of the OIG was an impediment to the IG's independence. The Chairman also told us that the second member had advised him that he should not proceed with the review of the OIG and that he planned to discuss the matter with GAO.

The Chairman told us that he viewed this conversation with a member of Congress as a threat, so he instructed the General Counsel to prepare a "defensive" letter responding to the member's call. The letter was sent to the member on May 26. In the letter, the General Counsel provided background information concerning TVA's proposed review of the OIG, starting with a discussion concerning the Chairman's receipt of the anonymous management complaint. The General Counsel explained that he had initially advised the Chairman that the Board had the authority to hire an outside contractor to review the OIG but subsequently suggested that the Chairman seek a mutually satisfactory agreement with the IG in which the IG would have contracted for the review. He noted that during this period, the Chairman had received information from an independent source that the IG had abused his TVA credit card "to pay for charges at

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golf courses, the purchase of liquor and excessive restaurant charges." We determined that these allegations had not come from an independent source but instead were the result of a preliminary review of the IG's credit card statements by the CAO's office.

On the afternoon of May 26, 1999, the IG sent the Chairman a 7-day letter claiming that the Chairman was interfering with the operations of the OIG and engaging in harassment. As evidence of this, the IG pointed to the proposed independent review of the OIG. He also noted his discussion with the Chairman regarding the Dickey acquittal and opined that the Chairman essentially had threatened him not to investigate any more cases involving senior TVA officials. Further, he felt that the Chairman intended to hold the threat of an outside review over his head if he did so. The IG also provided details about the May 25 conversation with the CAO, in which the CAO had told him the Chairman was reviewing his travel expenses.

On June 2, 1999, the Chairman sent you a letter responding to the IG's 7-day letter. The Chairman asserted that he had acted in a manner that was sensitive to the status of the IG but did not respond on a point-by-point basis to the IG's allegations.

TVA and IG Used Media to Publicize Their Opposing Allegations

According to the Chairman, on May 26, 1999, he ordered that the TVA letter to the Representative be released to the press because he knew that the IG's 7-day letter would be released to the public within the next 7 days. After the letter to the Representative was released, a reporter with the *Knoxville News Sentinel* interviewed the IG about the allegations concerning his abuse of the TVA credit card. During the interview, the IG described the issues he raised in his 7-day letter, including a description of the May 14 and 25 conversations with the Chairman and CAO, respectively.

On May 27, 1999, the CAO issued a statement to the media denying the IG's allegations. In part, the CAO said,

"TVA takes the position there is no justification for the Inspector General to be spending his time during the work day socializing and playing golf with managers whose operations he is charged with monitoring as TVA's independent watchdog. In our view, the Inspector General should be independent of management and avoid even the appearance of any actions that might be deemed inappropriate and would result in an OIG investigation."

On May 28, 1999, the news media received information contained in the May 27 memorandum prepared for the CAO, which analyzed the IG's credit card charges. This memorandum alleged that the IG had incurred \$15,150 in

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potentially questionable charges from a casino/hotel, resorts, golf course fees, liquor purchases, and restaurants. The memorandum failed to disclose that these particular charges had been incurred over an approximately 5-year period (1994-1999).¹⁶ TVA officials have denied providing this information to the media.

TVA Referred Issues Involving IG to ECIE

After receiving a facsimile copy of the newspaper article entitled "Prosser: TVA wants me out of there," an OMB official spoke to the TVA General Counsel about the allegations raised in the article. The OMB official indicated that the issues between the IG and TVA should not be fought in the newspapers. She added that if TVA had serious concerns about the IG's actions, the matter should be referred to the PCIE Integrity Committee.

As a result of OMB's advice, by letter dated June 1, 1999, the Chairman referred the matter concerning the IG's questionable credit card charges to ECIE's Chairman. In the referral, the TVA Chairman requested a review of the IG's credit card charges including questionable country club, hotel/casino, golf, liquor, and other charges. The Chairman also provided information about the two anonymous OIG personnel complaints.

On June 7, 1999, the ECIE Chairman forwarded the matter to the Chairman of PCIE's Integrity Committee. On June 25, the CAO's office provided documents to the Integrity Committee regarding the IG's alleged misconduct. Included was the May 27, 1999, "Preliminary Credit Card Review" with attached schedules. Based on the unsubstantiated information provided by the TVA Chairman, the Integrity Committee forwarded the matter to the Department of Justice. The FBI is currently reviewing the matter.

On August 20, 1999, after being informed that the FBI was investigating allegations against the IG, the Chairman placed the IG on paid leave.

Press Release and Media Leaks Occurred After Referral to ECIE

On June 2, 1999, TVA released to the press (1) the letter to the Chairman of the ECIE requesting the investigation of credit card charges by the IG and (2) the two anonymous complaints raising management issues within the OIG.

¹⁶ This disclosure was made in the May 20, 1999, draft of this memorandum from the senior manager to his supervisor, the CAO.

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On July 23, 1999, TVA announced in a press release that it had revised its policy on the employees' use of agency credit cards for business travel and entertainment. The announcement stated that additional controls would be placed on TVA's hospitality policy and that the number of TVA credit cards would be decreased. The announcement added that the Chairman was requiring the OIG to develop a similar entertainment policy for the OIG for the Chairman's approval. The Chairman stated in the release that these changes were prompted by allegations that the IG had more than \$10,000 in charges on his credit card for meals, liquor, golf, and other entertainment.

On August 17, 1999, two documents were leaked to the media. One was a June 24, 1999, memorandum identifying a number of new allegations against the IG. The other was a July 21, 1999, letter from the Chairman to GAO in which the Chairman opined that it would appear inappropriate for an inspector general to spend significant time or resources on customer relations. TVA denied releasing both documents to the media.

The allegations that the June 24 memorandum contained included, among others, that the IG had participated in sports betting while at work, was absent from his office frequently because he was socializing and playing golf, and had failed to investigate a matter involving a TVA executive because of their close relationship. We reviewed several of the allegations in the memorandum and found them generally to be without merit. For example, we found that the IG had investigated allegations against all three Board members, including the official alluded to, and against friends of this official.

**Chairman and IG Did Not
Receive Crucial Information**

During our investigation, we determined that in two instances the Chairman and the IG had failed to receive crucial information that might have impacted on the resolution of the management-review issue. The Chairman based his decision for a management review in part on the belief that the OIG had not been reviewed in 5 years. We determined that during this 5-year period, the OIG had had two peer reviews. The last peer review was completed on August 21, 1998. It concluded that the TVA OIG had a system of quality controls that provided with reasonable assurance for the OIG's conformance with professional standards in the conduct of its audits. According to the Chairman, he was not aware that a peer review had been completed in August; and if he had known, it would have affected his decision to order a management review of the OIG. He added that he most likely would have postponed the review. The IG told us that he never thought to inform the Chairman about the peer review.

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According to the IG, he was never offered the option of selecting from three other OIGs to conduct this review. Further, he would not have objected to such a review because, in his opinion, any IG conducting the review would have remained independent and would not have allowed the Chairman to have oversight of the review. However, this information was not conveyed to the Chairman; and the disagreements between the IG and the Chairman escalated significantly. After the Chairman criticized the IG about the Dickey case, TVA initiated an extensive review of the IG's credit card expenses; and the IG concluded that the Chairman wanted to get rid of him.

The Chairman alone initiated the process for a management review of the OIG. When the Chairman received the analysis of the IG's credit card usage for the IG's entire tenure, he began his most aggressive actions against the IG. This occurred after Directors Hayes and Kennoy had left TVA. The Chairman's actions against the IG included the release of unsubstantiated allegations to the media and the referral of unsubstantiated allegations to the ECIE. These actions could be viewed as an attempt to undermine the IG's independence.

Chairman's Allegations Concerning IG's Credit Card Expenses

Based on its "brief preliminary review" of the IG's credit card statements, TVA questioned a total of \$15,150 in charges for the years 1994 through 1999. (See table 1.) We reviewed in depth the IG's most recent charges—\$14,197—from January 1, 1998, to May 12, 1999. As to these, we did not find that the IG had violated any TVA travel policy or rule. However, as the IG himself recognized, his actions could have created the appearance that his independence had been compromised. Based on this analysis, we determined that a further analysis of credit card charges for the period 1994 through 1997 was not warranted. In addition, for comparison purposes, we requested TVA to compile credit card expenses for calendar year 1998 for the three Board members and the senior executives that report directly to the Board. This comparison indicated that the IG's credit card expenses were consistent with those of other TVA executives. See appendix I for this comparison.

IG's Travel Activities Were for Business Purposes or "Customer Relations"

As the head of a major office at TVA, the IG often traveled in connection with his position. For example, he traveled to attend meetings in his capacity as an ECIE representative on a PCIE committee. In other instances, he attended TVA Board meetings or met with congressional members and staff to present OIG reports. These activities clearly do not

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raise questions as to the purpose of the travel and were reimbursable as long as the expenses fell within the guidelines set out in TVA's travel policies.¹⁷

The IG also incurred expenses as a result of activities that involved "customer relations." The IG was a member of TVA's Business Council and, as did the other Council members, participated in the customer outreach activities. These activities were done at the specific behest of former Director Hayes, who was most concerned with TVA's maintaining or increasing its market share for electric power. Director Hayes also emphasized that it would be beneficial for the IG to take part in recreational events, such as golf outings that were ancillary to various meetings, that TVA planned as part of its program of customer relations. Moreover, he specifically encouraged the IG to bill the charges to TVA. The IG had initially paid for his own golf and charged the cost to TVA only when Director Hayes told him that such charges were consistent with TVA's policy regarding allowable expenses for hospitality.

The Chairman was aware of the IG's involvement in the customer relations program and told us that he considered this activity completely appropriate for the IG as long as his activity had been coordinated with Director Hayes. Director Kennoy also told us that it was appropriate for the IG to engage in customer relations.

The IG's involvement in the customer relations program was coordinated with Director Hayes. The IG never reached out to any distributors but attended functions only when requested by the Customer Relations and Marketing Group, which had responsibility for administering the customer relations program. Essentially, the IG attended various meetings with distributors at which the IG would discuss the IG Act, his background, and the role of the OIG at TVA. The IG also assisted certain customers in dealing with problems that were similar to those encountered by an IG. For

¹⁷ TVA travel policy required that TVA pay for travel expenses incident to business purposes for such things as transportation, lodging, meals, and other approved expenses in accordance with TVA guidelines and the Federal Travel Regulations, which are applicable to most civilian employees of the federal government. In this regard, TVA reimbursed business travelers for such items as meals, local transportation, lodging, laundry/dry cleaning, parking, phone expenses, and other incidentals. The reimbursement for meals, lodging, and laundry/dry cleaning was limited to 150 percent of the locality rate set by the General Services Administration (GSA) for civilian employees of the federal government in a travel status. However, since 1997, in special and unusual circumstances the maximum reimbursement can be up to 300 percent of the locality rate set by GSA.

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example, the IG assisted one company in setting up an ethics program and another company in setting up an improved financial control system. He felt that all of these activities were beneficial to his office.

In performing his customer relations function, the IG sometimes paid the bill for other TVA employees, Board members, and customers. In some instances, the IG paid the bill when another TVA official could also have paid it. In other situations, the IG was the only TVA person present who could have paid the bill.

As part of its business practices, TVA had hospitality guidelines, which provided that hospitality was available to official visitors, candidates for employment, guests, and employees as a part of its business activities when it was determined to be in TVA's best interest. The guidelines further provided the following:

"Hospitality services provided for and paid for by TVA may include but are not limited to:

- Meals.
- Refreshments.
- Banquet or food services.
- Room and equipment rental associated with hospitality.
- Lodging, meal and travel expenses for visitors and guests.
- Entertainment.
- Flowers and decorations for events (as determined by the TVA organization).
- Recognition awards.
- Gifts."

OIG had written policies indicating that the OIG followed TVA policy except for some modifications based on the OIG's unique role under laws and regulations. Nothing in these laws and regulations precluded the IG from engaging in hospitality functions and incurring the type expenses provided for in the hospitality policy. Indeed, the OIG policy specifically indicated that, in accordance with TVA policy, OIG employees may pay hospitality expenses for non-OIG individuals for a business purpose, such as to improve relations with individuals that TVA worked with on a regular basis.

The IG did acknowledge that his close relationship with members of the Board and his participation in TVA-sponsored social events could have created the appearance that his independence had been compromised. He continued, however, that he had participated at the Directors' behest. He felt that participating in these activities enabled him to maintain a good working relationship with the Board. He concluded that his participation did not impede his independence.

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Contested Charges for 1998-1999 Were Appropriate Table 1 details the TVA-questioned expenditures by category and the cost incurred for each year from 1994 through mid-May 1999.

Table 1: IG's Questioned Charges Based on TVA's Preliminary Review

Category of expenditure	1994	1995	1996	1997	1998	1999*	Total
Hotel/casino	\$0	\$0	\$68	\$68	\$247	\$147	\$530
Golf resorts	489	480	218	629	2,384	180	\$4,380
Liquor	0	0	0	0	303	0	\$303
Nonlocal restaurant charges	493	254	1,793	1,548	1,669	162	\$5,919
Local restaurant charges	225	621	0	1,139	1,013	385	\$3,383
Other questionable charges	0	95	32	328	0	180	\$635
Total	\$1,207	\$1,450	\$2,111	\$3,712	\$5,616	\$1,054	\$15,150

*We examined 1999 charges made through May 12.

Source: May 27, 1999, TVA memorandum to the CAO, entitled "Preliminary Credit Card Review - George Prosser."

We reviewed the charges in each category for 1998 and 1999. Based on the TVA travel and hospitality policies, we found that none of these charges violated TVA policies regarding the incurring of expenses for business and hospitality purposes. Specifically, we found the following as to these charges.

Hotel/Casino

TVA alleged that the IG had incurred hotel and casino expenses in Philadelphia, Mississippi, on three occasions in 1998 and 1999, totaling \$394. In 1998, the IG went to Philadelphia twice: in February, for a TVA Board meeting followed by other business meetings and in October, for an OIG presentation that he made in Philadelphia and a contiguous city. The expenses charged for these trips were for lodging. In 1999, the IG went to Philadelphia for a Joint OIG/TVA presentation made at Mississippi State University. On this trip, the IG charged the room expenses for himself and the Chief Financial Officer, who also made a presentation. These expenses were all appropriate.

Golf Resorts

On seven occasions in 1998 and once in 1999, the IG played golf following either an official TVA meeting, such as the monthly meeting of the TVA Board, or an OIG presentation involving customer relations. His expenses for these golf activities during this period totaled \$892 and ranged from \$45

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to \$276. In several instances, the IG paid the golf fees for TVA customers, as he did when he incurred the \$276 expense. The IG's golf expenses were consistent with the TVA hospitality policy.¹⁸

The IG also charged \$1,672 at the Power Play Golf Tournament, a major event sponsored by TVA and its customers to raise scholarship money. This amount covered the IG's lodging and golf fees. In addition, some of this amount covered the expenses of another OIG employee who attended in order to ensure the accountability of the funds raised at the event. This employee did not have a TVA credit card, and the IG charged all the employee's expenses. The IG also paid certain expenses for customers. As a senior official at TVA, the IG's payment of these expenses was consistent with the TVA's hospitality policy. Indeed, other TVA executives incurred charges on their TVA credit cards for golf fees and lodging similar to those of the IG.

Liquor

On one occasion, the IG purchased liquor, which cost about \$303, as an accommodation for Director Hayes who was going to make the purchase so that alcohol would be available at an official TVA dinner in a "dry" county. At the time, Director Hayes had a family emergency, which prompted the IG to make the purchase. Clearly Director Hayes could have purchased this liquor under the TVA hospitality policy, and we found no policy or rule that would prohibit the IG from substituting for a Director.

Nonlocal Restaurant Charges

During 1998 and 1999, the IG allegedly charged a total of \$1,831 at restaurants on 15 different occasions. These charges ranged from \$35 to \$163, except for one of \$500. In every instance, the IG was on official business including meetings involving audits, with confidential informants and members of Congress, or attendance at official TVA functions. In certain instances, the IG paid for meals for others. For example, the \$500 charge occurred in Washington, D.C., when the IG charged the cost of a meal served at a business meeting he attended with members of the Congressional Committee having oversight of TVA. All of these expenses were consistent with TVA travel policy and rules.

Local Restaurant Charges

Some expenses that were not incident to travel were called into issue. For the period we reviewed, these expenses totaled \$1,398 and covered meals

¹⁸In one instance, the IG paid the golf fees for Director Hayes. Since Director Hayes was clearly authorized to charge TVA for this expense and the IG was authorized to make such payments when in the best interest of TVA, we find the IG's action unobjectionable.

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that the IG purchased in the Knoxville area on 17 occasions. The costs of the meals ranged from \$10 to \$156, except for one that was \$582. In most instances, the IG conducted a business meeting during lunch and paid for all participants. For example, he met with the Special Agent in Charge of the FBI's Knoxville Field Office on at least three occasions in 1998 on matters of mutual concern and paid for the meals. He also held business lunches with confidential informants and paid for these. Three charges during 1998 were related to a meeting that the IG had with representatives from the OIG of the National Archives and Records Administration. TVA policy permitted the IG to charge these meals while he was engaged in official business. Lastly, a \$582 charge was for an employee appreciation luncheon, which was covered under the TVA hospitality policy.

Other Questionable Charges

TVA also raised questions about miscellaneous charges the IG had incurred. Four of these arose in the 1998 and 1999 time period we reviewed. One was a charge of \$43 the IG had made for a personal item; he had immediately reimbursed TVA even though he was not asked to do so. A second charge involved \$732 airline tickets that the IG never used. We were informed that this was due to an administrative error that eventually resulted in TVA's account being credited for the amount. A third charge consisted of \$118 for flowers for an official TVA event. In this instance, a Director had asked the IG to order the flowers for customer appreciation. The fourth charge, for \$19, was for publications for the OIG. The purchase of flowers was covered under the TVA hospitality policy. We determined that the publications purchase was needed for the work of the OIG.

Scope and Methodology

We conducted our investigation from June 9, 1999, through September 7, 1999. We interviewed TVA officials involving both TVA's attempt to retain a nonfederal entity to conduct a management review of the OIG and the analysis of the IG's TVA credit card usage. We also interviewed current and former OIG officials regarding the OIG performance review issue and the IG's use of the TVA credit card. Further, we contacted individuals from OMB, FBI, Verner Lipfert, and the U.S. Attorney's Office for the Eastern District of Tennessee regarding their conversations with TVA officials. The Department of Justice denied our request to interview the U.S. Attorney for the Eastern District of Tennessee.

We analyzed records related to both the management review and charges that the IG made using a TVA credit card. These records included internal memoranda, notes, contract files, audit reports, and policy manuals.

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regarding OIG travel and hospitality expenses. We also reviewed quality standards for IGs. In addition, we reviewed the IG's calendars for 1994 through 1999 and invoices for charges to the TVA credit card for 1996 through 1999. Receipts for 1994 and 1995 were no longer available. Further, we reviewed a detailed analysis of the IG's travel, by trip, for calendar year 1998 and the first 5 months of 1999. The IG also provided written explanations for expenses he had incurred during 1998 and 1999 and for all charges for golf resorts for the period 1994 through May 1999.

As agreed with your office, unless you release its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies of this report to the Honorable Craven Crowell, Chairman, Tennessee Valley Authority; George Prosser, Inspector General, Tennessee Valley Authority; and interested congressional committees. We will also make copies available to others upon request. If you have questions concerning this report, please contact me or Donald Fulwider at (202) 512-6722. John Ryan was a key contributor to this case.

Sincerely yours,



for

Robert H. Hast
Acting Assistant Comptroller General
for Special Investigations

Appendix I

1998 Credit Card Charges by TVA Board, IG, and Senior Executives

Table 2: 1998 Domestic Charges by TVA Officials

Official ^a	Hotel ^b	Meals ^b	Transport ^c	TVA plane	Other business expense	Personal vehicle use	Golf	Liquor	Other ^d	Subtotal
Chairman Crowell	\$11,309	\$3,848	\$15,398	\$56,294	\$0	\$491	\$0	\$0	\$1,042	\$88,382
Director Kenney	4,341	1,271	7,468	52,860	0	707	0	0	1,661	\$68,308
Director Hayes	6,134	1,270	8,326	27,042	0	105	90	0	844	\$43,811
IG Prosser	4,453	2,758	5,381	0	0	1,342	1,174	303	74	\$15,485
Chief Financial Officer	11,685	4,471	1,089	0	1,304	0	120	0	0	\$18,669
Chief Operating Officer	3,659	79	447	0	1,025	0	120	0	0	\$5,330
CAO	3,079	874	549	0	3,994	0	120	0	0	\$8,616

^aTVA's General Counsel charged no domestic expenses during 1998.

^bThis category does not include direct bills to TVA. It includes only the amount charged on the VISA Gold Card.

^cTransport includes commercial flights, travel service, car rentals, taxis, gasoline, and parking.

^dOther includes conference fees, telephone calls, tips, and facsimiles.

Appendix I
 1998 Credit Card Charges by TVA Board, IG,
 and Senior Executives

Table 3: 1998 International Charges by TVA Officials

Official ^a	Hotel ^b	Meals ^b	Transport ^c	Other business expense	Other ^d	Subtotal	Total 1998 charges
Chairman Crowell	\$2,284	\$484	\$14,678	\$0	\$8	\$17,454	\$105,836
Director Kenney	585	151	1,740	0	12	2,488	\$70,796
Director Hayes	0	0	0	0	0	0	\$43,811
IG Prosser	0	0	0	0	0	0	\$15,485
Chief Financial Officer	1,806	27	0	24	0	1,857	\$20,526
Chief Operating Officer	0	0	0	724	0	724	\$6,054
CAO	0	0	0	0	0	0	\$8,616

^aTVA's General Counsel charged no international expenses during 1998.

^bThis category does not include direct bills to TVA. It includes only the amount charged on the VISA Gold Card.

^c"Transport" includes commercial flights, travel service, car rentals, taxis, gasoline, and parking.

^d"Other" includes conference fees, telephone calls, tips, and facsimiles.



NEWS RELEASE

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SENATOR THOMPSON RELEASES GAO REPORT ON TVA INSPECTOR GENERAL DISPUTE

WASHINGTON — U.S. Senator Fred Thompson (R-TN) today released the results of a General Accounting Office (GAO) investigation he requested into the dispute between the Tennessee Valley Authority (TVA) Board of Directors and the TVA Inspector General (IG).

In its report to Senator Thompson, the GAO concluded that:

- “The (TVA) Chairman’s actions could be viewed as an attempt to undermine the independence of the IG.”
- “We found no evidence of TVA credit card misuse by the IG for the period we analyzed in depth... On the issue of whether the expenditures were in accord with applicable TVA policy, we determined that all of the questioned charges -- including charges for hotels, restaurants, golf, and liquor -- had been incurred as a result of activities undertaken at (TVA) Director Hayes’ direction and conformed to TVA policies.”

“I believe that this matter was badly mishandled by Mr. Crowell and TVA management,” Senator Thompson said. “While they certainly have the right to encourage the proper people to look at the allegations against their inspector general, here they overreacted to disagreements they were having with Mr. Prosser and tried to use unfounded allegations against him in order to discredit him, instead of going through the proper process. I have tried to be fair to Mr. Crowell, but I am getting a little tired of TVA’s self-inflicted wounds.”

To address the problems identified in the GAO report, Senator Thompson called for the following actions:

- **Legislation to restructure the TVA Office of Inspector General.** Thompson said that the TVA Inspector General should be appointed by the President, not the TVA Board of Directors, and should be confirmed by the U.S. Senate. He also said that the President should be the individual vested with the authority to remove the TVA IG, not the TVA Board. This is the case with other large federal agencies. “Congressman Duncan has a bill in the House and I am going to work with him and others in the TVA Caucus to get this done,” Thompson said.

(more)

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- **Swift Confirmation of Nominees to Fill Current TVA Board Vacancies.** Thompson called on the President to send his nominees for the two vacant TVA Board positions to the Senate as soon as possible. Thompson said he would push for their confirmation by the Senate prior to adjournment this fall.

"The GAO report clearly demonstrates the need for a full complement of TVA Directors," Thompson said. "The President should send us his nominees so we can consider them as soon as possible."

- **TVA needs to Re-examine its Entertainment Policy.** "I see no reason why so much time and money should be spent entertaining utility executives," Senator Thompson said. "And never under any circumstances should the TVA inspector general be involved. Mr. Prosser should have known better, but so should the Board who approved this policy."
- **Appointment of a New Acting IG.** Senator Thompson also expressed concern about the fact that the Acting IG appointed by TVA came from TVA management and has expressly stated that he intends to return to TVA management. He noted that, in similar situations in the past, another Inspector General (from a different agency) has agreed to take over the office to maintain the appropriate wall of separation between management and the IG. The panel established by the President to oversee all IGs offered to find another IG to temporarily run the office for TVA. However, TVA failed to take them up on the offer.

"The appointment of a management executive to serve as Acting IG raises troubling questions," Senator Thompson said. "This person will have access to all audit, whistleblower, and other confidential files during his tenure in the Office of Inspector General. That information should not be funneled back to management. I would hope that TVA would reconsider its decision and allow another IG to fill this position until this matter is resolved."

Senator Thompson had requested the GAO investigation in early June.

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The full text of the GAO report is available on Senator Thompson's Web Page at <http://www.senate.gov/~thompson>.

