



TACIR

The Tennessee Advisory Commission
on Intergovernmental Relations



4

Suite 508
226 Capitol Boulevard Building
Nashville, Tennessee 37243-0760
Phone: (615) 741-3012
Fax: (615) 532-2443
www.tn.gov/tacir

MEMORANDUM

TO: TACIR Commission Members

FROM: Harry A. Green *Harry*
Executive Director

DATE: December 7, 2011

SUBJECT: Commission Report to General Assembly on TVA PILOT

The Electric Generation and Transmission Cooperative Act (Public Chapter 475, Acts of 2009) directed TACIR to

- consider whether the current wholesale power supply arrangements between the Tennessee Valley Authority and municipal utilities and electric cooperatives are likely to change in the future in a way that could affect payments in lieu of taxes from the Tennessee Valley Authority to the state and to its local governments;
- report written findings to the Commerce, Labor and Agriculture Committee of the Senate; the Commerce Committee of the House of Representatives; the Finance Committee of the Senate; and the Finance Committee of the House of Representatives; and
- include recommendations, if any, on adjustments to the state tax system that would keep the state and local governments whole from such future changes.

The following year, the General Assembly passed Public Chapter 1035, Acts of 2010, based partly on TACIR's June 2010 report, *The Electric Generation and Transmission Cooperative Act of 2009 and Its Possible Impact on the Tennessee Valley Authority's Payments in Lieu of Taxes*. Public Chapter 1035 made the 2010 study an annual requirement.

The attached report will be presented for your approval as TACIR's 2012 report to the General Assembly.

Potential for Changes in the Tennessee Valley Authority Payments in Lieu of Taxes to Tennessee and Its Local Governments

By Reuben Kyle, Ph. D. & Lynnisse Roehrich-Patrick, J.D.

A provision of the Electric Generation and Transmission Cooperative Act of 2009 (Section 4 of Public Chapter 475, Acts of 2009) charged the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) with monitoring changes in the wholesale distribution of electric power by the Tennessee Valley Authority (TVA) and its distributors for possible effects on the Authority's payments in lieu of taxes (PILOTs). TACIR's report was to "include recommendations, if any, on adjustments to the state tax system that would keep the state and local governments whole from such future changes."¹ After considering a number of options, the Tennessee General Assembly passed Public Chapter 1035, Acts of 2010, (see Appendix) requiring payments equivalent to TVA's Tennessee PILOT from any other entity providing wholesale electric current for resale within the state, such as the electric generation and transmission cooperatives authorized in 2009. Public Chapter 1035 was designed to ensure that revenue from power sales in the TVA region would not depend on who produced that power or who sold it. The Act also renewed the requirement that TACIR monitor the effects of the 2009 act and report to the General Assembly annually. This is TACIR's report for the 2012 legislative session.

So far, only one cooperative has been formed: the Seven States Power Corporation (Seven States), a nonprofit formed by the Tennessee Valley Public Power Association. The cooperative purchased a 70% stake in an 810-megawatt, combined-cycle combustion turbine plant in Southaven, Mississippi, in September 2008. The co-op now owns 90% of the plant. TVA owns the remaining interest and, through a lease arrangement with Seven States, operates the plant. The co-op is considering a similar partnership with TVA to purchase and lease the 968-megawatt Magnolia combined-cycle gas-fired plant near Ashland, Mississippi.

TVA finds these arrangements attractive at least in part because Congress limits the amount of debt TVA can issue. The limit was last changed in 1979. The \$30 billion limit set then is the equivalent of only \$10 billion today. TVA's current debt is around \$27.4 billion.² Leases such as the current and proposed ones with Seven States allow the utility to meet increasing demand without incurring additional debt. In fact, the utility is considering selling some of its facilities in order to raise funds to build new ones and executing leases with the buyers similar to the current arrangement with Seven States. A recent TVA audit, however, suggests that, especially with today's low interest rates, these sales/lease-back arrangements may be more costly than borrowing.³

Because all revenue from sales of electricity produced by the Southaven plant flows through TVA, its ownership structure has no effect on TVA's total payments in lieu of taxes to the seven states in its operating region. The total PILOT would remain the same even if Seven States

¹ TACIR's June 2010 report, *The Electric Generation and Transmission Cooperative Act of 2009 and Its Possible Impact on the Tennessee Valley Authority's Payments in Lieu of Taxes*, is available online at http://www.tn.gov/tacir/PDF_FILES/Taxes/electric_generation_cooperative_act.pdf.

² See the September 2011 report, *History, Status, and Alternatives: TVA Financial Flexibility*, by TVA's Office of the Inspector General, available online at <http://oig.tva.gov/reports/audit-inpsections.html>.

³ Ibid.

were sole owner of the Southaven plant. The effect on the share of those payments received by each state is more complicated. Because TVA's payments in lieu of taxes to each state in the region depend in part on the value of the property it owns in each state, as TVA buys, sells, or builds power plants in each state, the share of the total PILOT coming to Tennessee may increase or decrease. This will happen regardless of who owns the plants that generate the power.

To be clear, this is only one factor that can affect TVA's PILOT to Tennessee or equivalent payments under the Public Chapter 1035. Other factors play a role, including energy conservation and the weather, as well as economic conditions and TVA's rate structure. But the location of power plants affects the allocation among states of half of the total TVA PILOT, so it is important to keep abreast of the building and trading of power plants that generate electricity sold in Tennessee regardless of who owns them. If TVA finds it necessary to sell some of its Tennessee properties, Tennessee's share of the total PILOT—or equivalent payments under Public Chapter 1035—may decrease even if sales in Tennessee remain the same. For the present, TACIR staff can only monitor such changes for potential effects on these payments.

Importance of TVA PILOTs

The TVA has made payments in lieu of taxes of nearly \$5 billion since federal fiscal year 2000 to the eight states affected by TVA power production. Of that sum, an average of 60% annually has come to the state of Tennessee and its local governments. For federal fiscal year 2012, 61.2% of TVA's total \$567.4 million PILOT or \$347.3 million will be paid to Tennessee and its counties. Taking the overlapping state and federal fiscal years and direct payments to counties of \$3.4 million by TVA into account, Tennessee will receive and allocate \$342.4 million during the state's current fiscal year. In addition to the direct payments from TVA, Tennessee counties will receive amounts ranging from \$192,082 in Pickett County to \$7.0 million in Shelby County through the state's allocation formula.⁴ Every incorporated municipality receives a share, as well, ranging from about \$936 (Saulsbury) up to \$7.7 million (Memphis). In other words, TVA makes a sizeable contribution to funding Tennessee's state and local governments. Consequently, the outlook for future payments is important at every level of government in the state.

The 1933 TVA Act requires payments in lieu of taxes, to states and local governments where the Authority owns and operates property, setting the amount at 5% of the agency's "gross proceeds" will be paid. TVA interprets the term gross proceeds to mean its operating revenues from the sale of power to municipalities, cooperatives, and industries but not from direct sales to federal agencies. A relatively small amount of the total payments, less than 1%, is paid directly to county governments based on the estimated value of TVA-owned property in each county.⁵ The state allocates the remainder according to a formula found in Tennessee Code Annotated, Title 67, Chapter 9, Part 1, and described in TACIR's June 2010 report to the General Assembly and depicted in the chart on the following page. The 48.5% retained by the state is paid into its general fund for appropriation by the legislature.

⁴ Tennessee Code Annotated, Title 67, Part 9, Chapter 1.

⁵ According to the 1933 TVA Act, payments made directly to counties are the 2-year average of ad valorem property taxes on power properties and reservoir land associated with power production.

Allocation of Tennessee Valley Authority Payments in Lieu of Taxes in Tennessee
(after direct payments to counties⁶ and 1977-78 base payment to state, counties, and cities⁷)

| | Basis of Apportionment <i>(§ 67-9-101)</i> | Proration to Counties & Municipalities <i>(§ 67-9-102)</i> |
|--|--|--|
| Paid to areas with TVA construction ⁸ <i>(remainder allocated to CTAS, TACIR, and Four Lakes Regional Development Authority)</i> | 3% | |
| Retained by the State ⁹ | 48.5% | |
| Paid to Local Governments ¹⁰ | 48.5% | |
| <i>Counties—70% of Local Share</i> <ul style="list-style-type: none"> • <i>Based on Percent of State Population</i> 30% <i>(14.55% of total)</i> • <i>Based on Percent of State Land</i> 30% <i>(14.55% of total)</i> • <i>Based on County's Percent of TVA Acreage in Tennessee</i> 10% <i>(4.85% of total)</i> | | |
| <i>Municipalities—30% of Local Share¹¹</i> | | 30% <i>(14.55% of total)</i> |

Factors Affecting TVA PILOTs

As noted in TACIR's past reports, a number of factors affect TVA revenues and PILOTs, including

- the national, regional, and local economies;
- unseasonal weather patterns;
- modernization of the region's power generation system;
- alternative financing strategies; and
- changes in the overall rate structure.

⁶ \$3,359,273 for federal fiscal year 2012.

⁷ \$55,204,586.

⁸ Construction activity on facilities to produce electric power.

⁹ Less amount required to guarantee Four Lakes 0.3% of total funds allocated (\$861,624 for state fiscal year 2012) per Tennessee Code Annotated § 67-9-102(b).

¹⁰ Less \$107,088 to TACIR per Tennessee Code Annotated § 67-9-102(a)(3) and amount required to guarantee CTAS 0.9% of total funds allocated and TACIR 1.2% of total funds allocated per Tennessee Code Annotated § 67-9-102(b)(3) (\$1,895,573 for the two combined for state fiscal year 2012).

¹¹ Payments to incorporated municipalities are based on the percentage that the population of that municipality bears to the population of all incorporated municipalities in Tennessee.

Forecasting TVA revenues and ultimately the PILOT is a very uncertain business. The eventual effect of these factors on the amount and distribution of the PILOT for Tennessee and its county and municipal governments remains to be seen. There will certainly be changes in the future resulting from the developments described here. In addition to the distribution among the states, the changes will also affect the distribution within the state among the county governments. What follows is a brief exposition of the potential effects of these factors on Tennessee's TVA PILOT.

External Factors—the Economy and the Weather

In November 2010, TVA reported that the PILOT to all eight states for federal fiscal year 2011 would amount to \$520 million dollars, a decrease of almost 3.4% from the previous year. This reduction was attributable to some unusual weather conditions and the slowdown in economic activity associated with the national economic recession. Total payments for 2012 will be back up to \$567.4 million, an increase of 9.1% over 2011 and 5.4% over 2010. TVA PILOTs to Tennessee for the state's most recent fiscal year were up only 1.9%, from \$315.4 million in fiscal year 2009-10 to \$321.5 million for fiscal year 2010-11. Payments for the current year will total \$342.4 million or 6.5% more than last year's payments and 8.6% more than the 2009-10 PILOT.

Generation System Modernization

Over the past year, there has been a great deal of news coverage about TVA's efforts to restructure its power system. First, in April of this year, TVA agreed to a settlement with the U.S. Environmental Protection Agency to invest a TVA estimated \$3 to \$5 billion on new and upgraded state-of-the-art pollution controls.¹² Plans include closing 18 coal-fired generating units over the next six years. Among the units to be closed are six generators at the facility in New Johnsonville, Tennessee, two of four units at the John Sevier plant in Rogersville, Tennessee, and six of eight units at the Widows Creek facility in North Alabama.

To illustrate the potential effects of these closures, consider the proposed changes at the New Johnsonville facility, which is located in Humphreys County. If TVA ultimately sold all of the land it currently owns there, some 29,519 acres, Humphreys County's payment under the formula described in the chart on the preceding page, would be reduced by half, from \$1.56 million to \$768 thousand. Tennessee's total PILOT would also decline if the Humphreys County acreage were removed from the formula TVA uses to allocate the PILOT among the seven states in its region. It should be emphasized that there will be no immediate impact of the announced closing on Humphreys County's—or Tennessee's—payments from TVA as the closing will occur over several years. Moreover, TVA has made no announcements about the property that it owns in the county.

Second, in the kind of move that could offset the effects of these closures on Tennessee's PILOT, in June 2011, TVA opened a new combined combustion unit that utilizes natural gas at the Lagoon Creek facility near Brownsville, Tennessee, in Haywood County, to make a total of 11 such facilities in the TVA system. And a combined-cycle unit is under construction at the John Sevier plant in Rogersville, Tennessee. To the extent that these new facilities increase the

¹² TVA will also invest \$350 million on clean energy projects that will reduce pollution, save energy, and protect public health and the environment. See U.S. EPA announcement on their website at <http://www.epa.gov/compliance/resources/cases/civil/caa/tvacoal-fired.html>.

value of TVA property in Tennessee relative to the value of its properties in other states in the region, Tennessee's share of the PILOT will increase.

Financing Strategies

During the summer of 2011, TVA's board of directors announced a plan to expand the use of nuclear generation capability. As a means of financing this expansion, TVA announced its intention to employ a sale/lease-back arrangement that would transfer ownership of its John Sevier combined combustion facility along with the Watts Bar Number 2 nuclear reactor to other owners. That financial arrangement would provide funding to expand the Bellefonte nuclear facility in North Alabama while allowing TVA to remain below its debt limit. The project is expected to cost \$4.9 billion.¹³

This proposal differs from the lease/lease-back arrangements TVA has used to raise revenue in the past in that TVA will relinquish legal title to the assets. The lease/lease-back arrangements allow TVA to retain title to its assets while raising cash for investment in new facilities, but unlike the lease/lease-back arrangements, they raise questions about whether they are actually indebtedness that should be counted toward TVA's debt ceiling. TVA has 24 such arrangements from which it has received approximately \$1.3 billion.¹⁴

By itself, a sale/lease-back agreement would not affect the total PILOT for all states since any power produced by those facilities would pass through TVA's books and be included in TVA revenues, but it could affect the distribution of the PILOT among the states involved. Any reduction in the amount of TVA property in Tennessee would result in a decrease in Tennessee's share of the total TVA PILOT and an increase in the share going to other states. And if, for example, the amount of TVA properties in Tennessee were reduced while the amount of property in Alabama increased, there would be a transfer of PILOT monies from Tennessee to Alabama.

The release of TVA's most recent audit¹⁵ sparked new interest in raising its debt limit, though as noted in the audit report, the nation's weak economy and the fact that any increase in TVA's debt adds to the overall federal debt means raising the debt ceiling would be difficult, even if it could be demonstrated that issuing debt would be less costly than these sales/lease-back arrangements. U.S. Senator Lamar Alexander has spoken out strongly in favor of granting TVA more flexibility in financing its modernization efforts, saying

*I believe TVA needs flexibility in its debt and I'm willing to consider any proposal they present to me. It (TVA) needs to go ahead with the nuclear power plant, so if TVA thinks it needs more flexibility with its debt, I'm perfectly willing to consider that.*¹⁶

¹³ See <http://www.tva.com/news/keytopics/bellefonte.htm> accessed online 6 December 2011.

¹⁴ See the September 2011 report, *History, Status, and Alternatives: TVA Financial Flexibility*, by TVA's Office of the Inspector General, available online at <http://oig.tva.gov/reports/audit-inpsections.html>.

¹⁵ Ibid.

¹⁶ See Chattanooga Times-Free Press article dated 1 September 2011, *Sen. Alexander open to raising TVA debt ceiling*, accessed online at <http://timesfreepress.com/news/2011/sep/01/sen-alexander-open-to-raising-tva-debt/> on 17 November 2011.

Even with Senator Alexander's support, however, raising the debt limit or replacing it with a limit based on something more flexible (e.g., its debt coverage ratio) will be difficult in the current economic climate.

Other Factors

Finally, and not to be played down, a big influence on overall TVA revenues is power rates, which are affected by several things as well. For example, on November 14, 2011, TVA announced a 2.8% rate increase because December demand is projected to be 16% higher than November demand, and TVA expects to use higher cost resources. Purchased power is expected to contribute half of the increase in cost.¹⁷ Other things equal, this rate increase will increase TVA revenues and, consequently, the PILOT. Energy savings through improved efficiency will ultimately affect revenues, as well, when TVA sells less power, which will reduce its revenue, again other things equal. The point is that forecasting TVA revenues and ultimately the PILOT is a very uncertain business.

The eventual effect of these changes on the amount and distribution of the PILOT for Tennessee and its county and municipal governments remains to be seen. There will certainly be changes in the future resulting from the developments described here. In addition to the distribution among the states, the changes will also affect the distribution within the state among local governments.

¹⁷ See <http://www.tennessean.com/article/20111114/NEWS21/111114023/TVA-says-fuel-cost-2-8-percent-higher-December> accessed online 17 November 2011.

PUBLIC CHAPTER NO. 1035

SENATE BILL NO. 3333

By McNally

Substituted for: House Bill No. 3504

By Fitzhugh

AN ACT to amend Tennessee Code Annotated, Title 48 and Title 67, relative to electricity.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE:

SECTION 1. Tennessee Code Annotated, Section 48-69-103(6), is amended by deleting the semicolon at the end of subsection (6) and by adding the following language:

, and "governmental electric system" may, at the election of the G&T cooperative for purposes of membership in the G&T cooperative, include the Tennessee Valley Authority, all as provided in the bylaws of the G&T cooperative.

SECTION 2. Tennessee Code Annotated, Section 48-69-106(b), is amended by adding the following language as a new subdivision:

(13) Enter into one (1) or more agreements providing for the making of payments in lieu of taxation to any state or local taxing jurisdiction within or outside this state to the extent that the G&T cooperative's wholesale sale of capacity and energy to a member or patron of the G&T cooperative results in a diminution in payments in lieu of taxation from the Tennessee Valley Authority to such state and local governments. For purposes of this subdivision (b)(13), "payments in lieu of taxation" means payments made by the Tennessee Valley Authority to state and local governments on account of its gross proceeds under § 13 of the Tennessee Valley Authority Act of 1933, compiled in 16 U.S.C. § 831I. All such payments shall be ordinary operating expenses of the G&T cooperative.

SECTION 3. Tennessee Code Annotated, Title 67, Chapter 4, is amended by adding the following as a new part:

§ 67-4-3101.

(a) It is the intention of this part to establish an obligation to make in lieu of tax payments to help keep Tennessee and its local governments whole from any diminution in the in lieu of tax payments paid by the Tennessee Valley Authority on account of the provision of wholesale electric current to municipal utilities, electric cooperatives and other similar entities for resale within the state by sources other than the

Tennessee Valley Authority. Accordingly, each person, including each governmental and cooperatively organized person, engaged in the business of making covered wholesale sales of electric current to a municipality, electric cooperative or other similar customer shall, for the privilege of doing such business, remit to the state for state purposes a payment in lieu of tax in an amount to be calculated in accordance with subsection (b).

(b)(1) For purposes of this section:

(A) "Covered wholesale sales of electric current" means wholesale sales of electric current for resale within any area where the Tennessee Valley Authority is the primary source of wholesale power as of the effective date of this act;

(B) "Gross receipts" means the total gross receipts derived from all covered wholesale sales of electric current;

(C) "Tennessee apportioned gross receipts" means gross receipts multiplied by a ratio obtained by taking the arithmetical average of the following two ratios:

(i) The percentage by which the gross receipts derived from covered wholesale sales of electric current occurring within Tennessee bears to the total gross receipts derived from all covered wholesale sales of electric current; and

(ii) The percentage by which the book value of the power property held in Tennessee by the seller of covered wholesale sales of electric current bears to the book value of all power property held by the seller of covered wholesale sales of electric current. The book value of power property shall include that portion of the investment allocated or estimated to be allocable to power.

(2) The payment in lieu of tax required pursuant to subsection (a) shall equal five percent (5%) of the Tennessee apportioned gross receipts of the person making covered wholesale sales of electric current.

(c) There shall be credited upon the in lieu of tax payments required by this section any taxes paid pursuant to Parts 3, 4, 20, or 21 of Chapter 4 of this title by or on behalf of the person engaged in a covered wholesale sale of electric current on account of the ownership or operation of electric generation facilities and other property used to generate, transmit or distribute such electric current. There shall be further credited upon the in lieu of tax payments required by this section

any ad valorem taxes or payments in lieu of ad valorem taxes paid to the State of Tennessee or local governments within the state by or on behalf of the person engaged in a covered wholesale sale of electric current on account of the ownership or operation of electric generation facilities and other property used to generate, transmit or distribute such electric current.

(d) If the person making covered wholesale sales of electric current does not make the required in lieu of tax payment calculated in accordance with subsections (b) and (c), then each municipality, electric cooperative or other similar customer engaged in making use of covered wholesale sales of electric current shall be responsible for making such payment in lieu of taxes applicable to the customer's use of such power and energy. Only one (1) in lieu of tax payment shall be required for a single sale and use of a covered wholesale sale of electric current.

(e) This section and the required in lieu of tax payments do not apply to any wholesale sale of electric current to or by the Tennessee Valley Authority or to any power property held by or attributed to the Tennessee Valley Authority.

(f) Any in lieu of tax payment collected pursuant to this section shall be added to the amounts received by the state from payments in lieu of taxes from the Tennessee Valley Authority and the combined amount shall then be distributed according to the provisions of § 67-9-101.

(g) Except as otherwise specifically provided in this section, the in lieu of tax obligations required by this section shall be administered and collected in the same manner as privilege taxes are administered and collected under Part 3 of this chapter.

SECTION 4. The Tennessee Advisory Commission on Intergovernmental Relations is directed to continue to monitor, within existing resources, whether the current wholesale power supply arrangements between the Tennessee Valley Authority and municipal utilities and electric cooperatives are likely to change in the future in a way that could affect payments in lieu of taxes from the Tennessee Valley Authority to the state and to its local governments. No later than February 1, 2011, and annually thereafter, the Tennessee Advisory Commission on Intergovernmental Relations shall report written findings to the Commerce, Labor and Agriculture Committee of the Senate; the Commerce Committee of the House of Representatives; the Finance, Ways and Means Committee of the Senate; and the Finance, Ways and Means Committee of the House of Representatives. The report shall include recommendations, if any, on adjustments to the state tax system that would keep the state and local governments whole from such future changes.

SECTION 5. This act shall take effect upon becoming a law, the public welfare requiring it.

PASSED: June 3, 2010



RON RAMSEY
SPEAKER OF THE SENATE



KENT WILLIAMS, SPEAKER
HOUSE OF REPRESENTATIVES

APPROVED this 11th day of June 2010



PHIL BREDESEN, GOVERNOR