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The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: Commission Members

FROM: Cliff Lippard
Executive Director

DATE: 29 September 2020

SUBJECT: Issues Affecting Future Tennessee Valley Authority Payments in Lieu of Taxes

As directed by the Electric Generation and Transmission Cooperative Act of 2009 (Section 4 of Public Chapter 475, Acts of 2009), the Commission in January published its annual report on payments in lieu of taxes (PILOTs) made by the Tennessee Valley Authority (TVA) to the states in the Valley region. Since then, TACIR staff has been monitoring two issues the January report identified as having potential effects on future PILOT amounts: the status of TVA's long-term wholesale power contracts with local distributors, and consideration that one of TVA's largest distributors—Memphis Light, Gas and Water (MLGW)—is studying whether to leave the TVA system. In addition, Tennessee and the Valley region have been dealing with the spread of COVID-19 (novel coronavirus disease). Since early March, businesses in the region and around the country have closed or limited operations. Although many have reopened or increased operations over the last few months, the resulting decrease in demand for electricity is still affecting TVA revenue, which in turn will reduce future PILOT amounts. This memo serves as an interim update to the Commission on these important topics.

Long-Term Wholesale Power Contracts

Historically, local power companies (LPCs) could opt out of their contracts with TVA subject to termination notice requirements of five, 10, or 20 years. In August 2019, TVA began to offer LPCs new 20-year long-term contracts ("Partnership Agreements") that include a 3.1 percent bill credit applied to the LPC's base rate monthly wholesale power bills. At the time of the Commission's January report, 131 of TVA's 154 LPCs had signed new agreements. Since then, Chattanooga (EPB), Huntsville (Huntsville Utilities), and

Knoxville (Knoxville Utilities Board) have signed, among others bringing the total to 141 as of August 3 when TVA reported its third quarter financial results. The 3.1 percent credits reduce the amount of revenue TVA uses to calculate the overall PILOT. Through the first nine months of its fiscal year (i.e. June 30, 2020), TVA reported $108 million in partnership credits—a 1.6 percent reduction in total revenue from sales of electricity to local power companies—reducing the overall PILOT for all states by $5.4 million (5% of $108 million). Tennessee's reduced share of that is approximately $3.6 million. However, assuming Tennessee's LPCs benefitted from the same share of the credits, that amounts to $72.4 million in savings to them.

As noted in the Commission's January report, TVA's revenue from sales of electricity could decrease by up to $225 million over a full federal fiscal year with all 154 distributors signed to the long-term agreements, reducing the total PILOT amount by $11.3 million. Tennessee's share would decrease by about $7.5 million. Distributions through the state's formula would decrease by up to $3.8 million for the state, $2.6 million for counties, and $1.1 million for cities, based on Commission staff calculations and distributions in state fiscal year 2019-20.

Other credits, including "economic development credits to promote growth in the Tennessee Valley, hydro preference credits for residential customers of LPCs, and interruptible credits allowing TVA to reduce industrial customer usage in periods of peak demand" have always reduced the revenue from sales of electricity amount that TVA uses to calculate the PILOT to states. In each of the past three federal fiscal years, TVA reported an average of $648.3 million in "Other charges and credits," reducing the total PILOT amount by $32.4 million each year. Tennessee's share of that is about $21.6 million.

Status of Memphis Light, Gas and Water (MLGW)

Memphis Light, Gas and Water (MLGW), which serves the cities and unincorporated areas of Shelby County, currently has a contract with a 5-year termination notice—and has not agreed to a new 20-year partnership contract. In April 2019, MLGW began a yearlong process of developing an Integrated Resource Plan (IRP), hiring Siemens Industry Incorporated "to evaluate MLGW's existing and future load requirements and propose supply and transmission deliverability scenarios to meet these in a reliable and cost-effective manner," including the possibility of leaving the TVA. The draft IRP was presented to MLGW's Power Supply Advisory Team (PSAT) on May 29, 2020, and a community engagement meeting on June 4 began a required 30-day public review period.

The draft IRP contained several "portfolios" for MLGW to obtain power supply for its customers. These alternatives were compared with MLGW's current contract with TVA and with a potential 20-year partnership agreement (e.g. including the 3.1% credit) across several performance metrics: least cost, reliability, resiliency, sustainability, etc. Most of the portfolios presented in the IRP involve a combination of MLGW generating some of its own power—by way of third-party construction of solar farms and natural gas combustion turbines—and purchasing the rest from the neighboring Midcontinent Independent System Operator (MISO) market. The IRP explains, "Since there are no existing transmission connections between MLGW and MISO, reliable and adequate transmission projects would have to be constructed for MLGW to take advantage of the MISO market." Three new interconnection projects are proposed in the IRP, each consisting of several miles of high voltage transmission lines, substations, and transformers, with a capital cost of $376 million. These projects would take 3-5 years to complete. Other transmission improvements and connection costs related to new units of local power generation bring total estimated transmission infrastructure costs to roughly $700 million. Despite these initial costs, the IRP determined that MLGW could expect "levelized cost savings of about $99 to $122 million per year" over a 20-year period if it leaves TVA.

At its June 17 meeting, the MLGW Board of Directors discussed the draft IRP and resolved to make a decision in August as to whether MLGW would seek requests for proposals (RFP) from power providers based on the final IRP. After the 30-day public review period ended July 6, MLGW published the questions and comments it received (LINK), and Siemens began to revise the document for final approval. MLGW and TVA each made presentations to the Memphis City Council on July 7. TVA believes that the IRP "significantly underestimates the risks and likely costs," and TVA presented several new initiatives, including a commitment to expand TVA's presence in Memphis by 100 employees, with particular emphasis on community revitalization. (LINK) TVA President Jeff Lyash made a similar presentation to the MLGW board on July 15. MLGW held another virtual listening session on August 17, which featured comments and presentations from several stakeholders.

In order to be ready to move forward when MLGW had a final IRP, the Memphis City Council approved $150,000 at its May 19 meeting for a consultant to issue an RFP to get actual prices from power suppliers. At its August 19 meeting, the MLGW Board of Directors made the recommendation to hire a consultant to manage the power supply RFP process. The board intends on having that consultant in place by late October. The final power supply RFP process will take into consideration the information in the IRP, and it could be 12 to 18 months before a decision is made to obtain power from a specific supplier other than TVA. Only then (Fall 2022 / Spring 2023) would the five-year TVA contract termination period begin.

PILOT Implications if MLGW Leaves TVA

As mentioned in January's commission report, power purchased by MLGW constitutes approximately 9% of TVA's wholesale power revenue and represents 13.5% of power purchased by LPCs in Tennessee. Eliminating that revenue from the calculation of TVA's PILOT to the states reduces the total PILOT by nearly $50 million. Tennessee's share of TVA's power sales would drop from 67% to 63%, and Tennessee could see its PILOT amount reduced by nearly $42 million. The other states in the TVA region would also receive less PILOT money (the remaining $8 million) due to the loss of revenue from MLGW.

There is a provision in Tennessee law that could restore some of that money. Public Chapter 1035, Acts of 2010 (Tennessee Code Annotated, Section 67-4-3101), requires entities other than TVA selling wholesale electric power to local power companies to make PILOTs to the state. In 2018, MLGW purchased 14,331 GWh of wholesale power from TVA; the IRP predicts that amount will decrease over time to around 13,400 GWh. IRP portfolio 9 is one of the best-performing alternatives according to the study's metrics. In that scenario, MLGW would purchase approximately 30% of its energy from market providers. Using the IRP projections, MLGW would need 13,539 GWh of power in the year 2028—what could likely be the first full year without TVA. 30 percent of that would be 4,062 GWh purchased through energy markets. At an average wholesale price of $40/MWh, MLGW would be purchasing $162.4 million worth of electricity. Based on staff understanding of Tennessee Code Annotated, Section 67-4-3101(b), the seller would be responsible for a PILOT to the state of approximately $4 million.

The actual amount of PILOT owed to the state will depend on how MLGW and its new suppliers structure their contracts. Tennessee law reduces this PILOT if the supplier pays other taxes: "There shall be credited upon the in lieu of tax payments required by this section any taxes paid pursuant to part 3, 4, 20, or 21 of this chapter…" Staff estimated an example company selling electricity to MLGW could be liable for approximately $890,000 in excise and franchise taxes, reducing the state's PILOT by that amount to around $3.2 million. Where MLGW locates any new power plants and who owns them will determine other possible local PILOT amounts. The final IRP report says, "In this IRP all generation facilities are assumed to be owned by third parties that would enter into a Power Purchase Agreement with MLGW, therefore the developer will be paying property and income taxes, and MLGW will not be subject to a PILOT."

Regardless of the final portfolio and structure MLGW chooses for its power supply if it leaves TVA, fiscal year 2028 would potentially be the first year of significantly reduced revenue, resulting in possible lower PILOT amounts for 2029.

COVID-19 is reducing TVA revenue, which will reduce future PILOT amounts.

Since early March, businesses in Tennessee and the Valley region have closed or limited their operations due to the spread of COVID-19 (novel coronavirus disease). While many have since reopened or increased their activity, there has still been a decrease in demand for electricity, which is affecting TVA revenue, and which in turn will reduce future PILOT amounts. In the nine months ending June 30, 2020, TVA reported $7,158,000,000 in revenue from sales of electricity to local power companies and direct industrial customers—$710 million (9%) less than the same period in 2019. And according to its August 4 press release, "TVA anticipates base revenue could be as much as $100 million lower than plan for the fourth quarter of 2020 due to impacts of COVID-19."

Based on TVA's reports and statements through the first three quarters of its fiscal year 2020, staff estimates revenue from sales of electricity to local power companies and direct industrial customers in FY 2020 could be $893 million less than FY 2019, resulting in a PILOT total for all states of approximately $507 million. On August 27, 2020, TVA announced the final PILOT figures for each state for FY 2020. ("TVA Tax Equivalent Payments Total Nearly $552 Million in FY20") Tennessee's PILOT was reported as $372.8 million—67.6% of the total amount. Applying the same share to our projected total for FY 2021 would mean Tennessee's PILOT next year would be approximately $342.7 million—about $30 million less than the current year.

Revenue from Sales of Electricity (in millions)				
	Local Power Companies	Industries Directly Served	Total	Change 2019-2020
FY 2019 1Q	$2,467	$185	$2,652	
FY 2019 2Q	2,514	168	2,682	
FY 2019 3Q	2,366	168	2,534	
FY 2019 4Q	3,004	165	3,169	
FY 2019 Total	$10,351	$686	$11,037	
		PILOT for FY 2020:	**$551.7**	
FY 2020 1Q	$2,357	$150	$2,507	-145 (-5.5%)
FY 2020 2Q	2,301	160	2,461	-221 (-8.2%)
FY 2020 3Q	2,058	132	2,190	-344 (-13.6%)
FY 2020 4Q			2,986*	-183 (-5.8%)*
FY 2020 Total			$10,144*	-893 (-8.1%)*
		Estimated PILOT for FY 2021:	**$507.2***	

*Staff calculations based on statement that "TVA anticipates base revenue could be as much as $100 million lower than plan for the fourth quarter of 2020 due to impacts of COVID-19."