The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: Commission Members

FROM: Cliff Lippard
Executive Director

DATE: 17 December 2020

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

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As directed by the Electric Generation and Transmission Cooperative Act of 2009 (Section 4 of Public Chapter 475, Acts of 2009), in January 2020, the Commission 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. 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 could reduce future PILOT amounts. Staff prepared a memo for the Commission in September as an interim update on these important topics, and this additional memorandum provides recent updates for your information. A draft of the 2021 update to the annual report is in progress and will be presented to the Commission for review in January 2021.

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 2020 report, 131 of TVA's 154 LPCs had signed new agreements. As of November 16, the number was up to 142. These LPCs were responsible for 81.5% of TVA's revenue from sales of power to LPCs and 75% of total operating revenue in federal fiscal year 2020.

Long-term partnership credits were valued at $163 million in TVA's 2020 fiscal year, reducing the potential overall PILOT by $8.1 million. Based on TVA's projected revenue for FY 2021, the credits could total between $190 and $200 million—more if additional LPCs sign on. 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.

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. Responding to changes in TVA's wholesale rate structure in 2018, as well as a number of outside studies suggesting MLGW could save significant amounts of money by leaving TVA and buying its power elsewhere, MLGW hired Siemens Industry Incorporated to prepare an Integrated Resource Plan (IRP)—an extensive document that would "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, presented to MLGW's Power Supply Advisory Team (PSAT) on May 29, 2020, described several "portfolios" for MLGW to obtain its power supply and compared these alternatives with MLGW's current contract with TVA and with a potential 20-year partnership agreement that would include the 3.1% credit. Most of the portfolios presented in the IRP involve a combination of MLGW generating some of its 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

* Following the merger of Middle Tennessee Electric and Murfreesboro Electric, effective July 1, 2020, there are now 153 LPCs.

(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.

Following public review and feedback, including a response to the draft from TVA, MLGW's Board of Commissioners approved the final IRP in July. In August, the board issued a request for proposals (RFP) to hire a consultant to help it issue and evaluate the additional RFPs necessary to obtain detailed quotes from companies willing to build infrastructure and supply power to MLGW. In September, the board recommended a $520,000 proposal from GDS Consultants and Stanley Consultants. The GDS proposal would be to issue three concurrent RFPs: one seeking bids for transmission components, one for new thermal generation (the recommended portfolios in the IRP include a need for new power plants), and one for power purchase agreements and renewable energy sources. Overall, MLGW and GDS said it could take 12 to 18 months to receive bids and decide what course to take. Because of the size of the contract, MLGW needs approval from the Memphis City Council to move forward with GDS.

However, some members of the council questioned the cost and lengthy timeline proposed. The council had already voted to approve a nonbinding resolution with $150,000 for the mayor to work with a different consultant, ACES, to issue an RFP for power bids, which MLGW said was not comprehensive enough to meet their needs. The council voted on October 6 to reject the GDS contract. When the MLGW Board of Commissioners met in November there was discussion regarding what options it can pursue in-house to issue RFPs—including hiring additional staff and purchasing software—or changes to the scope of the contract so it can take steps forward without council approval. If MLGW continues to move towards a bidding process for power outside TVA, it will likely be 12 to 18 months before a decision can be made. Only then, perhaps sometime in 2022, would the five-year TVA contract termination period begin.

While TVA says it "respects and supports MLGW's decision to pursue Request for Proposal's (RFP's) as it looks to its long-term energy supplier," it has refuted some of the findings in the IRP and has been making its case for MLGW to stay with it and sign a 20-year partnership agreement. When the draft IRP was released in June, TVA said "several key assumptions made by Siemens were inaccurate." In July, TVA offered several proposals to strengthen its relationship with Memphis, including decommissioning its Allen Fossil Site to enable the Port Development Project, contributing up to $10 million per year towards revitalization of core communities and opportunity zones, doubling its energy efficient homes program, and an expansion of TVA's Memphis headquarters that could bring 100 full-time employees. Because the cost of deferred maintenance to MLGW's transmission grid is a significant driver of increasing rates, TVA offered to purchase the system and integrate it into the TVA system, arguing this "would allow MLGW to reduce related operating and maintenance expenses, avoid future capital investment and could allow MLGW to reallocate capital into distribution system reliability improvements to reduce near-term ratepayer impacts." TVA has touted its nonprofit, publicly owned status as a benefit in comparison to investor-owned, for-profit companies. It has also pointed to its economic development strength and track record of reliability.

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 the power purchased by LPCs in Tennessee. Eliminating that revenue from the calculation of TVA's PILOT to the states may reduce 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 the 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. Thirty 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 that MLGW chooses for its power supply, if it leaves TVA, federal fiscal year 2028 would potentially be the first year of significantly reduced revenue, resulting in possible lower PILOT amounts for 2029 and beyond.

COVID-19 has reduced electricity demand thus decreasing TVA's revenue from power sales, which is one factor that may reduce 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 in turn, will reduce future PILOT amounts. For the federal fiscal year (FFY) ended September 30, 2020, TVA reported just under $10 billion in revenue from sales of electricity to local power companies and direct industrial customers—more than $1 billion (9.5%) less than FFY 2019.

On August 27, 2020, TVA announced the final PILOT figures for each state for FFY 2020, which were based on TVA's FFY 2019 revenue. Tennessee's PILOT was reported as $372.8 million—67.6% of the total amount. With FFY 2020 revenue down $1 billion, TVA's estimated PILOT amount for all states in FFY 2021 will be approximately $500 million—a decrease of more than $50 million overall. Tennessee's share is projected to be approximately $340 million, nearly $33 million less than the current year.

The state's fiscal year 2021 began in July 2020. PILOT payments Tennessee received in July, August, and September 2020 were based on Tennessee's $373 million share of the $552 total TVA PILOT for FFY 2020 that ended September 30. The state began receiving lower payments from TVA in October 2020—approximately 9% lower than last year—and will continue to do so through the end of the state fiscal year 2021 (June 2021) and into the first part of the state fiscal year 2022 (July-September 2021). TVA's revenue from the current federal fiscal year 2021—October 2020 through September 2021—will determine PILOT payments beyond that. In August 2020, the TVA Board approved a $200 million Pandemic Relief Credit that will apply to LPCs, their large commercial and industrial customers, and TVA's directly served customers as a 2.5 percent monthly base rate credit during 2021. With this credit and a slowly recovering economy, TVA is projecting FFY 2021 revenue will remain slightly below FFY 2020, meaning PILOT payments received in late 2021 and most of 2022 are likely to be similar to current amounts.