

Report of the Tennessee Advisory Commission on Intergovernmental Relations

**Tennessee Valley Authority's Payments in Lieu of Taxes**  
*Annual Report to the Tennessee General Assembly*

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## **Tennessee Valley Authority's Payments in Lieu of Taxes Annual Report to the Tennessee General Assembly**

The Tennessee Advisory Commission on Intergovernmental Relations (TACIR) was tasked by the Electric Generation and Transmission Cooperative Act of 2009 (Section 4 of Public Chapter 475, Acts of 2009) 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) to the states in the Valley region. The Commission'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." The Act authorized the creation of nonprofit membership cooperatives to generate and transmit electricity in Tennessee. At the time, one such co-op already owned a power-generating facility in Mississippi, and the legislature was concerned that, having authorized them, they had opened the door to a potential decline in TVA's payments to the states if the co-ops began selling electricity directly to distributors.

After considering a number of options, including those developed by the Commission,<sup>1</sup> the Tennessee General Assembly passed Public Chapter 1035, Acts of 2010, 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 the Commission monitor the effects of the 2009 act and report to the General Assembly annually. This is the Commission's report for the 2014 legislative session.

As noted in last year's report, while the 2010 law put to rest the immediate concern about the potential loss of TVA revenue created by the 2009 law, concerns about the problems created by TVA's debt ceiling, which has not been raised since 1979,<sup>2</sup> and the threat of privatization continue to grow. Both of these issues were among the reasons given by power distributors in the region for seeking authorization to form the generation and transmission co-operatives authorized by the 2009 Act. TVA's debt ceiling remains \$30 billion, which because of inflation has the buying power of about \$10 billion in today's dollars. The following graph shows the level of TVA's debt since 1998.<sup>3</sup>

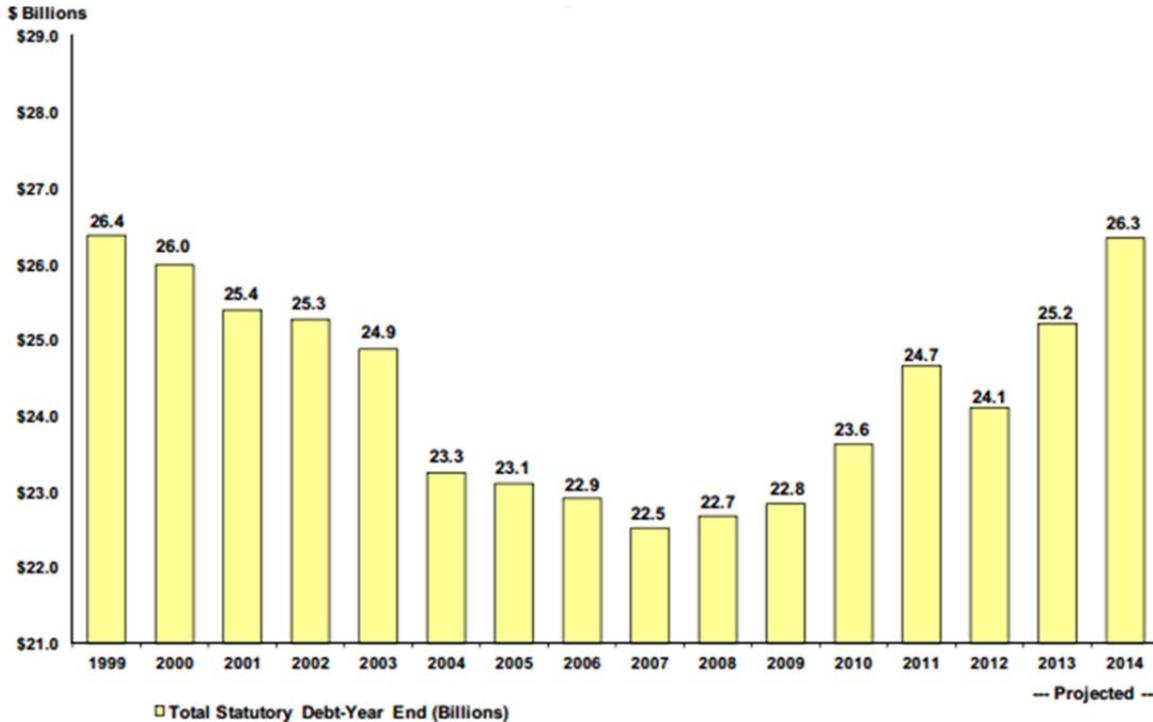
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<sup>1</sup>TACIR's June 2010 report, *The Electric Generation and Transmission Cooperative Act of 2009 and Its Possible Impact on the Tennessee Valley Authority's Payments in Lieu of Taxes*, is available online at [http://www.tn.gov/tacir/PDF\\_FILES/Taxes/electric\\_generation\\_cooperative\\_act.pdf](http://www.tn.gov/tacir/PDF_FILES/Taxes/electric_generation_cooperative_act.pdf).

<sup>2</sup>16 United States Code Section 831 n-4(a).

<sup>3</sup>Tennessee Valley Authority 2014 *Budget Proposal and Management Agenda*, Submitted to Congress April 2013, p. 28.

### Total Statutory Debt at Year End (in billions)



To manage within the \$30 billion debt limit, TVA has adopted a number of innovative but, by its own account, costly financing techniques, some of which can alter the amount of PILOT revenue paid directly to states. The lease-and-lease-back technique used so far to finance expansion of power production in Tennessee does not affect the amount of the PILOT paid directly to Tennessee, but the sale-and lease-back technique used at two of its plants in Mississippi reduced the amount paid directly to that state, and the potential for the same exists throughout the region. The difference is in who owns the property and whether it is subject to state and local taxes.

The management strategy laid out in TVA’s Integrated Resource Plan<sup>4</sup> could also affect the balance of PILOTs across the region. Changes in the supply system called for by the plan, brought about in part as a response to economic factors and environmental mandates, include closing a number of old coal-fired generation plants, acquiring new natural gas plants, and expanding nuclear-powered facilities. Demand management strategies in the plan, if successful, could actually reduce TVA revenues and ultimately the PILOT for all recipients. Staff will continue to monitor and report developments in the region that may affect TVA’s payments in lieu of taxes.

<sup>4</sup>Tennessee Valley Authority Integrated Resource Plan, Appendix C.  
[http://www.tva.com/environment/reports/irp/archive/pdf/Final\\_IRP\\_app.pdf](http://www.tva.com/environment/reports/irp/archive/pdf/Final_IRP_app.pdf)

## Decline in TVA's Payments in Lieu of Taxes

Federal fiscal year 2013-14 will be the second consecutive year in which TVA revenues and the PILOT declined from the previous year. Several factors played a role in this now two-year decline, but it is primarily a consequence of the slow economic recovery. According to a November 2013 press release,<sup>5</sup> TVA's actual payments in lieu of taxes in the region for federal fiscal year 2012-13 amounted to \$547 million, of which \$337.7 million was paid to Tennessee. The total is based on five percent of gross proceeds from power sales, and funds are divided among the states based both on revenues from power sold and on the value of power-generating property owned by TVA in each state.<sup>6</sup> Total payments of \$522 million were estimated for federal fiscal year 2013-14.<sup>7</sup> The projected decline in revenues is credited to the continued slow pace of economic recovery, the loss of a major direct industrial customer, greater energy efficiency, and a mild weather year.<sup>8</sup>

**Table 1. Tennessee Valley Authority Revenue Sharing**  
*Distribution Estimates\* by Federal Fiscal Year (in millions)*

	2013-14	2012-13	2011-12	2010-11	2009-10	2008-09	2007-08
TVA Payment to States	\$522.4	\$536.4	\$567.4	\$520.0	\$538.4	\$500.0	\$452.0
Tennessee's Percent	X 62.84%	61.69%	61.21%	60.64%	59.47%	58.06%	58.83%
Tennessee's Amount	\$328.3	\$330.0	\$347.3	\$315.3	\$320.1	\$290.3	\$265.9
Direct Payment to Counties	— 3.4	3.4	3.4	2.2	2.2	2.1	1.8
Tennessee's Share	\$324.9	\$327.6	\$343.9	\$313.1	\$318.0	\$288.2	\$264.1

\*TVA estimates payments in lieu of taxes each year based on unaudited prior year gross receipts and distributes these estimated payments monthly from October through August. It then makes a final payment for the year in September based on audited revenue figures for the previous fiscal year. It is not unusual for the final payment to be adjusted upward from the original estimated amount. Tennessee's amount minus direct payment may not sum to state share due to rounding.

The estimated decrease in payments to each of the 95 counties in Tennessee ranged from 2.2% to 2.9% with most counties losing 2.9% from the prior year. The largest estimated loss is for Shelby County, a \$194,029 decrease from its \$6.9 million payment for 2012-2013. The decline in estimated payments for the state's fiscal year 2012-13 amounts to \$2.7 million in the distribution to county governments, slightly more than \$1 million in the distribution to cities, and approximately \$3 million to the state and its agencies.<sup>9</sup> There is a small decrease in impact funds—money paid to areas with TVA construction—of \$193,000. See appendix A for an

<sup>5</sup>Tennessee Valley Authority, "TVA Tax Equivalent Payments Total \$547 Million in 2013, news release, November 19, 2013, [http://www.tva.com/news/releases/octdec13/tax\\_equivalents\\_2013.html](http://www.tva.com/news/releases/octdec13/tax_equivalents_2013.html).

<sup>6</sup>See appendix A for an explanation of TVA's formula for allocating its payments in lieu of taxes among the recipient states.

<sup>7</sup>The approved estimated tax equivalent payments are \$522,411,306 and scheduled to begin Oct. 1, 2013.

<sup>8</sup>The U.S. Enrichment Corporation of Paducah, Kentucky was TVA's largest single industrial customer. Tennessee Valley Authority, *10-K Report*, p. 11. <http://investor.shareholder.com/tva/secfiling.cfm?filingID=1376986-12-43>.

<sup>9</sup> The Tennessee fiscal year is from July to June. The federal fiscal year is from October to September.

explanation of Tennessee's allocation formula and appendixes B and C for the distribution to local governments within the state by county and city since state fiscal year 2006-07.

### **TVA's Efforts to Meet Power Needs and Remain Within its Debt Limit**

One concern for the future of TVA's PILOTs in the region and among Tennessee's counties is the effect of financing arrangements for new generating capacity. In order to stay within the \$30 billion debt ceiling imposed on it by the Congress in 1979, TVA has resorted to new financing methods that could affect the distribution of PILOT funds and negatively affect county and city funds. One technique is the leasing of some generating facilities.<sup>10</sup> Shortly before the Electric Generation and Transmission Cooperative Act was passed in 2009, TVA entered into an agreement with a group of its distributors organized as the Seven States Power Corporation, a non-profit company. Seven States purchased an interest in TVA's Southaven, Mississippi, power plant with the agreement that TVA would continue to operate it.<sup>11</sup> TVA later bought back most of Seven State's interest in the plant. Under the sale-and-lease-back arrangement while it was active, all sales of electricity produced at Southaven were through TVA and, therefore, were accounted for as TVA revenues and subject to the PILOT allocation to states.

Leasing arrangements such as the one used in Southaven during this agreement, do not change the total amount of the PILOT under the TVA formula, nor do they change the allocation across states. Section 15d(g) of the Tennessee Valley Authority Act of 1933 says that

*...power generating and related facilities operated by the Corporation under lease and lease-purchase agreements shall constitute power property held by the Corporation within the meaning of section 13 of this Act...*

This provision causes facilities operated by TVA under leases to be included in the calculation of the value of power-producing property under Section 13, which means that the value of TVA property in the lease-holding state does not change.

Although the change in ownership of the Southaven plant did not affect the PILOT allocation across states, it did affect the PILOT distribution to the state of Mississippi. The amount of the TVA PILOT that goes through any particular state's own allocation formula is decreased to the extent that the new plant owners must pay taxes to the state or local governments. Section 15d(g) of the 1933 act goes on to say

*...that portion of the payment due for any fiscal year under said section 13 to a state where such facilities are located which is determined or estimated by the Board to result from holding such facilities or selling electric energy generated thereby shall be reduced by the amount of any taxes or tax equivalents applicable*

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<sup>10</sup>For details on these arrangements see Tennessee Valley Authority 2013, *10-K Report*, p. 103 and 108. <http://investor.shareholder.com/tva/secfiling.cfm?filingID=1376986-13-56>.

<sup>11</sup>More information about the plant can be found on TVA's website at <http://www.tva.com/sites/southaven.htm>.

*to such fiscal year paid by the owners or others on account of said facilities to said state and to local taxing jurisdictions therein.*

The sale-and-lease-back arrangements of the Southaven plant and the Caledonia plant, also in Mississippi, illustrate the effect of this second provision.<sup>12</sup> Because of the change in ownership status, the plants were subject to state and local taxes. Consequently, Mississippi's allocation was reduced by approximately \$6 million in both 2012 and 2013.<sup>13</sup> This works much like the \$3+ million in direct payments TVA makes to counties in Tennessee. Direct payments are taken off the top of TVA's PILOT to each state, reducing the amount allocated through the state's statutory formula. The amount allocated through Tennessee's formula, including the amount retained by the state in its general fund, would be reduced by any taxes paid on account of any plant operated through a sale-and-lease-back arrangement, if that were to occur. Tennessee might want to mitigate that reduction by modifying its allocation formula to offset the direct payments of taxes by, for example, reducing the allocation to any particular jurisdiction by the amount of the reimbursement TVA made to the plant owners. It is possible, of course, that the reimbursement amount to those jurisdictions could be greater than the allocation through the state formula, so considerable thought would need to go into making such a change.

The following statement was included in TVA's 2013, *10-K Report*, filed with the United States Securities and Exchange Commission:

TVA may seek to enter into similar arrangements for other assets in the future, potentially including assets under construction. While such leasing transactions allow TVA to diversify its asset financing program, financing an asset by using the proceeds of leasing transactions is typically more costly to TVA than financing an asset with the proceeds of Bonds.<sup>14</sup>

TVA has chosen a somewhat different strategy to raise funds for generating expansions in Tennessee without approaching its debt ceiling. Thus far, arrangements in Tennessee have been lease-and-lease-back agreements, which fortunately do not jeopardize the amount of the PILOT controlled by Tennessee's allocation formula. An example is the natural gas combined cycle plant built between 2010 and 2012 in Hawkins County next to the John Sevier fossil plant and leased to a private company in January 2012. The company paid TVA \$1 billion for the lease and then leased the plant back to TVA for 30 years.<sup>15</sup> This lease arrangement changes neither the ownership of the property nor TVA revenues and thus has no effect on the PILOT across states or within Tennessee. Similarly, in August 2013, TVA repurchased the 90% share of the Southaven plant that Seven States had purchased. TVA then entered into a leasing

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<sup>12</sup>More information about the Caledonia plant can be found on TVA's website at <http://www.tva.com/sites/caledonia.htm>.

<sup>13</sup>E-mail from Stephen Schoolfield, Program Manager-Taxes, Tennessee Valley Authority, December 16, 2013.

<sup>14</sup>Tennessee Valley Authority 2013, *10-K Report*, p. 57.

<sup>15</sup>More information about the plant can be found on TVA's website at [http://www.tva.com/sites/johnsevier\\_cc.htm](http://www.tva.com/sites/johnsevier_cc.htm) and in the Tennessee Valley Authority 2013, *10-K report*, p. 100.

arrangement with Southaven Combined Cycle Generation LLC in which the facility is leased to the company and, in turn, the facility is leased back to TVA.<sup>16</sup>

### Rebalancing Power Sources and Increasing Efficiency Could Affect PILOTs

TVA's Integrated Resource Plan (IRP) calls for rebalancing its generation fleet, with 40% of its power generated at nuclear plants, 20% at coal plants, 20% at natural gas facilities, and the remaining 20% provided by hydro generation, renewable sources, and energy efficiency. These changes could affect the PILOT if they cause a shift in value of power-producing property from one state to another. Changes so far, including the change from coal to natural gas in Rogersville, which was made as part of an agreement with the Environmental Protection Agency (EPA), have occurred mostly at existing sites and so have not affected the value of TVA property or the PILOTs. The expansion of the Watts Bar nuclear operation now under construction in Rhea County could actually increase Tennessee's share of the PILOTs if it increases the value of that property. The closure of coal plants in Alabama and Kentucky announced this year and the opening of a new natural gas plant at an existing Kentucky site could also affect the payments across states.<sup>17</sup> Table 2 shows TVA's energy sources for the last three years.

**Table 2. Power Supply from TVA-Operated Generation Facilities**  
For federal fiscal years 2010-11 through 2012-13  
(millions of KWh)

	2012-13		2011-12		2010-11	
Coal fired	62,519	43%	58,584	41%	74,583	52%
Nuclear	52,100	36%	55,244	38%	49,562	34%
Hydroelectric	18,178	12%	12,817	9%	12,706	9%
Natural gas and oil fired	13,102	9%	16,650	12%	6,809	5%
Renewable resources (non hydro)	+9	<1%	25	<1%	17	<1%
Total	145,908	100%	143,320	100%	143,677	100%

Source: Tennessee Valley Authority, *10-K Report*, p. 12.

TVA's IRP also calls for a 3.5% improvement in efficiency by 2015 in order to reduce the need to increase capacity in the future. Some of that improved efficiency will occur through upgrading power transmission and distribution systems; some will occur in private homes and businesses. As customers update their homes, commercial and industrial facilities, and electrical appliances and equipment, those changes reduce existing power demand, which could reduce TVA revenues and ultimately the PILOT for all recipients if demand does not continue to grow with the population and the economy.

<sup>16</sup>Tennessee Valley Authority, "TVA Secures Lease-Purchase Financing for Mississippi Gas Plant," news release, August 9, 2013, [http://www.tva.com/news/releases/julsep13/miss\\_gas\\_plant.htm](http://www.tva.com/news/releases/julsep13/miss_gas_plant.htm).

<sup>17</sup>More information about the plant can be found on TVA's website at [http://www.tva.com/sites/johnsevier\\_cc.htm](http://www.tva.com/sites/johnsevier_cc.htm) and in the Tennessee Valley Authority 2013, *10-K report*, p. 100.