

Sarbanes-Oxley Impact - End-Use Billing

Consolidated Questions and Answers from Distributor Meetings

1. Is TVA going to communicate directly with distributor boards? Some do not know about TVA's request for SAS 70 reports.

Communications will take place through the distributor managers, with the expectation that managers will inform their boards.

2. Will distributors have to get board approval for this audit?

Most boards of directors would approve the audit firm selected to perform any audits for the distributor.

3. How do we respond to TVA's request for a SAS 70 when our auditors are telling our boards that distributors don't have to comply with Sarbanes-Oxley?

To meet Securities and Exchange Commission (SEC) filing requirements, TVA must be in compliance with the Sarbanes-Oxley Act. Section 404 of Sarbanes-Oxley requires TVA to report on the effectiveness of internal control structures and procedures for financial reporting. The unique nature of end-use rates requires distributors to calculate major portions of their power bills. Under Section 404, TVA must assess the effectiveness of its own internal controls over the end-use billing process, as well as related controls performed by distributors. For compliance with Sarbanes-Oxley, TVA's external auditor, Price Waterhouse Coopers (PwC), has advised TVA to obtain audit opinions on the effectiveness of distributor internal controls for end-use billing from independent CPA firms through a prescribed process outlined in Statement of Auditing Standards No. 70 (SAS 70). This assessment relates only to the distributor end-use billing process and will not address distributor internal controls in other areas.

4. Isn't Sarbanes-Oxley TVA's problem? Why do distributors have to go through the time and expense to comply with TVA's request? Why is TVA asking distributors to complete the audit?

Please refer to the answer to question 3 above. As explained, under Section 404, TVA must assess the effectiveness of its own internal controls over the end-use billing process as well as related controls performed by distributors. The consequence of a distributor not complying with TVA's request is that TVA could receive a qualified opinion from PwC. This would have negative consequences for TVA and distributors, including a possible credit downgrade for TVA. TVA is asking the distributors to complete this audit to achieve the necessary level of independence to avoid costly re-performance of audit work by PwC and minimize the total cost ultimately borne by the ratepayer.

5. Why can't TVA hire enough field accountants to do this work? In the past the field accountants performed the type of work that TVA is asking for in the SAS 70 audit plan.

The field accountants can answer questions the audit firms have on the SAS 70 audit plan; however, TVA must maintain an arms-length position to ensure that the audit is independent. Otherwise, PwC will have to re-perform much of the work at the distributor's office which will require distributor's reports to be filed much earlier and significantly increase the cost and time required to complete this review.

6. Will TVA provide a punch list for auditors to go through? What resources is TVA willing to provide? After the first test, the field accountants should inform the distributor staff of problems before they become material weakness.

The End-Use Billing Process Audit Plan lists the specific control objectives to be covered by the audit. The Plan also includes samples of an audit report and control objective test results. The field accountants can answer questions the audit firms have on the SAS 70 audit plan; however, TVA must maintain an arms-length position to establish that the audit is independent. Otherwise, PwC will have to re-perform much of the work.

7. Will training be available for area CPAs?

Formal training for area CPAs is not planned. The TVA field accountants can answer questions audit firms have on the SAS 70 audit plan.

8. Is TVA's requirement that an audit firm is in good standing with the AICPA sufficient to ensure that the firm is qualified to perform a SAS 70 engagement? Who is qualified to perform the audit? Can our current auditor do it?

To perform a SAS 70 review, your auditor must be qualified to assess the design and operating effectiveness of processing controls and the results of control testing as prescribed in AU Section 324. The accounting firms currently performing distributor financial audits should be able to meet this requirement. Most of the firms should be able to gain sufficient understanding of the end-use process to perform the audit. However, under AICPA auditing standards, firms should not agree to an engagement they are not qualified to perform.

9. Are there enough accounting firms in the Tennessee Valley to perform the SAS 70 engagements?

The requirements are that the audit be performed by an independent CPA who is a member in good standing with the AICPA. The accounting firms currently performing distributor financial audits should meet this requirement. Most of the CPA's should be able to gain sufficient understanding of the end-use process to perform the audit. Based on the conversations we have had with firms that have contacted us, there are a number of firms eager to perform this work.

10. If TVA offers both end-use and demand and energy rates, won't TVA have a way to ensure that the two rates are "revenue neutral" by calculating what a distributor's revenue should be under end-use rates? This type of calculation would enable TVA to "audit around" distributor controls.

TVA will continue to explore whether additional validation checks can be added in the future. However, reasonable assurance of adequate end-use revenue reporting controls must be obtained to ensure the accuracy of a historic revenue reporting baseline before TVA can develop other validation routines. Currently, TVA does not offer both end-use and demand and energy rates. If this happens in the future, there would have to be a transition phase before TVA could develop and test other validation routines that could be relied upon for control purposes.

11. Are these requirements only necessary because of end-use rates and billing?

Yes. This type of audit is required because of end-use rates. The unique nature of end-use rates and billing requires the distributors to calculate major portions of their power bills. Under Section 404, TVA must assess the effectiveness of its own internal controls over the end-use billing process as well as related controls performed by distributors.

12. Would the elimination of end-use rates eliminate the need for these audits? Do Sarbanes-Oxley requirements completely go away if TVA is billing on wholesale demand and energy rates?

Yes. The Sarbanes-Oxley requirements for distributor controls over the end-use billing process would no longer be necessary if end-use rates were eliminated. TVA would still comply with Sarbanes-Oxley requirements under wholesale demand and energy rates; however, TVA would perform and report on the effectiveness of its own controls, not those of the distributor. Where necessary, such as the application of credits, TVA field accountants may perform highly limited reviews of distributor records to assist in TVA's documentation and testing. Further testing at distributor's offices by TVA's external auditor would be minimal under this scenario unless the findings indicated a high risk to TVA.

13. Is TVA trying to force distributors to use wholesale demand and energy rates instead of end-use rates?

No, TVA is not mandating a change. Any change in the rate structure is to be worked out between power distributors and TVA through the rate change process.

14. Is TVA offering another rate structure that will exempt distributors from Sarbanes-Oxley? Is TVA going to offer another rate structure so that distributors don't have to go through this SAS 70 process?

Changing the rate structure is an issue between power distributors and TVA. If requested, TVA will work with distributors to develop demand and energy rates through the rate change process.

15. Can TVA legally make distributors comply?

Based on the TVA Power Contract with distributors and third party billing processors, TVA has rights to financial information from distributors. Based on new legal requirements for TVA's compliance with the Sarbanes-Oxley Act, this financial information is necessary. Although SAS-70 reports are not specifically identified as a requirement, this is necessary for TVA's compliance based on the end-use rate structure currently in use. In order to attain compliance and maintain the end-use structure, this has to be done.

16. Isn't the distribution loss factor/annual true-up sufficient to keep TVA whole? Why doesn't the loss true-up provide the accuracy that TVA needs?

The distribution loss factor provides some level of assurance that power usage is recognized and reported; however, the true-up does not compensate for errors associated with misapplication of rate codes to end customers' usage. Additionally, there is no means to validate demand-related charges. Revenues derived from end-use billing customers represent over 80% of TVA's reported revenue. TVA must assess the effectiveness of its own internal controls over the end-use billing process as well as related controls performed by distributors.

17. What is the timing / need for this data, and what is the status of a "test" year?

TVA has reviewed the initial requirement for a test year after receiving input from distributors. As a result, distributor compliance for Fiscal Year (FY) 2005 will be on a voluntary basis. FY 2006 (ended September 30, 2006) is the first year TVA's financial reporting will be subject to SEC oversight and Sarbanes-Oxley compliance becomes mandatory. TVA has received further guidance from its auditors since the original SAS 70 audit plan was released that more time will be needed for compilation and analysis of distributor results prior to year-end reporting deadlines. Consequently, TVA is accelerating the deadline for the distributor SAS 70 audit reports from October 1 to August 31, 2006 to better prepare for PwC and potentially SEC review.

18. When will TVA notify the power distributors if they are included in the list to be audited?

For FY 2006, all distributors will be audited. For future years, TVA will work with the Tennessee Valley Public Power Association (TVPPA) to develop a selection process through which TVA can obtain assurance on controls associated with at least 70 percent of revenues generated from municipalities and cooperatives and adequately address known risk factors such as evidence of control issues or past billing discrepancies. All 158 distributors will be reviewed at least once during the course of a three-year cycle. TVA will notify the affected distributors by January 1 of each year.

19. Can the testing be done on the distributors' fiscal year (first 6 months of 2006 FY-July 2005-January 2006?). Most distributors don't see their CPAs until after April 15-tax time.

The SAS 70, Type II reports should be prepared for internal controls in place as of a point in time to be determined by the distributor. However, the "as of" date should be as close to TVA's September 30 fiscal year end as possible but definitely within the preceding six-month period (i.e. April 1 through September 30, 2006) to avoid the need for additional procedures to update the relevant information.

20. All residential requirements should be the same. TVA is not vague about that. Will there be a comparison distributor by distributor on rate class reporting?

No, TVA will not make comparisons between distributors. Classification is defined in the language of the Power Contract Rate Schedule-Availability section, and TVA will continue to respond to any questions or address issues with individual distributors regarding application of the language.

21. One control point references testing meters. What about residential meters? How often must they be tested?

TVA will not mandate your process. The control objective referencing meter testing has been revised to include only commercial and industrial meters used for demand charge calculations.

22. Doesn't TVA need to establish some parameters for consistency (limit the leeway) such as the number of years that a certain class of meters will be tested and what constitutes residential service, etc.?

Again, TVA will not mandate your processes. Each distributor is responsible for the processes they perform. Processes should be adequate to provide reasonable assurance of the accuracy of end-use billing reporting.

23. Distributors need guidance on how to report and classify. This should be consistent, shouldn't it? It's not a level playing field if all distributors are not reporting the information the same. Can TVA give some guidance on customer classifications?

Classification is defined in the language of the Power Contract Rate Schedule-Availability section, and TVA will continue to respond to any questions and address issues with individual distributors regarding application of the language.

24. What is meant by periodic meter audits? Does TVA mean that all meters must be tested every 3, 5, or 10 years?

The frequency of periodic meter audits must be sufficient to provide reasonable assurance that the data is accurate. The periodic audits should follow a documented policy, and the process will depend on the type of meter and history of meter malfunctions.

25. Is TVA asking distributors that use meter readers and route books to convert to total electronic reading of meters to reduce the chance of keying errors?

No. TVA is asking that controls and procedures be in place and related documentation is for review and attestation by their auditor. Whatever the process, it is critical that adequate documentation is available the auditor to review and provide assurance that the process is adequately controlled. We see no reason why meter readers and route books cannot provide reasonable assurance.

26. Why is TVA requiring distributors to bear the cost of compliance when it is TVA's requirement to comply?

TVA is willing to pay the direct cost of external auditors, and we are working with TVPPA to determine the best way to go about this. However, we are reluctant to agree to pay for any additional internal costs since those costs would be considerably more difficult to quantify and subject to debate. We will be working with TVPPA to develop an equitable solution for all distributors.

27. It appears there is some uncertainty about the scope of this audit requirement. Also, when will a decision be finalized as to the cost? Can the cost of the audits required by Sarbanes-Oxley compliance be shared by TVA or included in the rates?

TVA is working with TVPPA to determine the best approach for paying audit costs.

28. How will TVA pay the distributor for the extra audit? Will the distributor be credited? Will TVA allow the distributor to increase the rates to fund the audit?

TVA is working with TVPPA to determine the best approach for paying audit costs.

29. How locked into the control objectives is TVA? (Why 18, could less be checked or other items)?

TVA has reviewed and revised the End-Use Billing Process Audit Plan to streamline and consolidate control objectives where there was redundancy. Control objectives addressed by other control activities or considered less significant in the process were removed. As a result, the 18 control objectives have been reduced to 12.

30. Can distributors decide not to comply with these requirements and ask for a different wholesale rate schedule? What is the consequence of not complying with TVA's request?

If a power distributor doesn't assist with compliance, another rate option could be considered.

31. Are these the very minimum requirements that will satisfy TVA's reporting under the Sarbanes/Oxley Act? Is there another way to comply with Sarbanes/Oxley that is simpler and less costly?

TVA has considered several approaches and solicited advice from its external auditors and another independent CPA firm. TVA is confident that the proposed End-Use Billing Process Audit Plan represents the most practical approach considering our current rate structure.

32. What about reactive meters. Some distributors don't put reactive meters on customers. Shouldn't this be fair across the Valley?

Appropriate metered demand between TVA and the distributor must be in place to accurately report wholesale power purchases. The installation of reactive meters is beneficial to distributors by ensuring accurate retail billing of the distributor's customers. If the wholesale reporting to TVA is impacted by a lack of metering; other procedures must be in place to accurately capture the demand reported for these customers.

33. Will TVA request the SAS 70 reports from the billing agencies or should the distributor request one from them also? Has TVA already given these requirements to the billing agencies?

TVA can request a separate SAS 70 report from the billing agencies; however, the business relationship with these agencies belongs to the distributor. TVA has provided some information informally to most of the billing agencies as requested.

34. How will TVA help the distributor address any deficiencies discovered in the audit? If materially weaknesses are found, will they still be allowed to utilize end-use rates until remediated?

TVA will do what it can to help distributors address any deficiencies. This process is new to TVA, as well, and we will make every effort to help with remediation where possible. It is important that continuous improvement is made to address material weaknesses. Material weaknesses should be addressed in a timely manner and remediated controls should be tested to ensure compliance by the next report date.

35. Is this the final process or can distributors contact their local representatives to see if changes can be made that will exempt TVA from this requirement?

Distributors always have the option to contact their local representatives about issues; however, this requirement is driven by legislation that has already been passed by Congress in December 2004, which places TVA under SEC reporting requirements and the associated Sarbanes-Oxley Act compliance.

36. Has an independent CPA firm (other than PwC) reviewed these requirements and agreed that TVA is subject to the provisions of Sarbanes/Oxley as related to End-Use Billing? If so, can distributors see that report?

Yes, an independent CPA firm, other than our external auditor (PwC), has reviewed the requirements and agreed that TVA is subject to the provisions of Sarbanes-Oxley for the end-use billing process. TVA has offered to coordinate a meeting between this firm and the TVPPA to discuss the findings.

37. Are distributors still under PURPA?

TVA is still the PURPA regulator.